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Report,
1969.

REPORT OF THE CANADIAN COMMITTEE ON MUTUAL FUNDS AND INVESTMENT CONTRACTS

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Provincial and Federal Study
1969

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PREFACE

This Committee was established pursuant to a decision at a meeting of the Prime Ministers and Premiers of the Provinces of Canada in August 1966, which adopted a recommendation of the Canadian Securities Administrators made during a conference in October 1965. The Committee was organized at a Federal-Provincial Conference of Officials on Financial Disclosure and Securities Regulation in November 1966, when the federal government agreed to participate together with the provincial governments. The Committee is thus in the unusual and perhaps unique position of a body with a responsibility to make recommendations to all eleven jurisdictions concerning the legislation and regulations applicable to certain financial institutions.

The willingness of the eleven jurisdictions to join in the sponsorship of this Committee is an excellent indication both of the national interest in the mutual fund and investment contract industries and of the increasing tendency towards co-operation among the provinces and between the provinces and the federal government in the regulation of all our financial institutions. Each of these points is further confirmed by the content of this report. Our factual conclusions provide ample confirmation that the mutual fund and investment contract industries transcend provincial boundaries, and the regulatory structure we propose is an excellent example of the reasons why federal-provincial co-operation in the regulation of financial institutions is not only desirable, but essential.

In part because of the nature of the organization of this Committee, we decided that it was important for us to make our recommendations sufficiently specific that they could be readily implemented through legislation and regulations. While, for reasons indicated in Chapter XIX the recommendations do not deal in detail with the allocation of responsibilities between the provincial governments and the federal government, they are very specific concerning the contents of the regulatory scheme we propose. The time required to formulate a detailed scheme was one of the principal factors which has resulted in delay in the completion of this report.

The creation of this Committee was the result of a number of factors. Most of them related to the spectacular growth of mutual funds, a term used here, as throughout this report, to refer to the companies often described as open-end investment companies. The growth of the mutual fund industry, combined with the important changes in investment attitudes indicated by that growth, aroused great interest. From a regulatory standpoint, the interest was accentuated by awareness that mutual funds were subject to a variety of legislation, most of it not specifically tailored for them and much of it difficult to apply to them. There was also concern with the lack of regulatory provisions designed to deal with problems involved in the increasing tendency of other financial institutions to issue instruments competitive with those issued by mutual funds. The investment contract industry was included within the scope of the study for reasons indicated in the introductory note to the report.

Another factor which encouraged the creation of this Committee was the publication in March 1965 of the report of the Attorney-General's Committee on Securities Legislation in Ontario. Appendix "D" to that report indicated that a number of submissions concerning mutual funds had been received, but concluded that an adequate study of mutual funds would have to extend to other financial institutions issuing similar or competitive instruments. A separate study for this purpose was recommended.

Mr. J.R. Kimber, Q.C. was the Chairman of this Committee at the beginning of our work. He resigned from the Committee in June 1967 following his appointment as President of the Toronto Stock Exchange. We are grateful to

Mr. Kimber for his efforts on our behalf in the formative stages of the Committee. The only other change in the membership of the Committee during the course of its work was the resignation of Mr. F.C. Tapley following his appointment as Director of the Manitoba Securities Commission. Mr. Tapley made a valuable contribution to the Committee's discussions. We regretted the departures from the Committee both of Mr. Kimber and of Mr. Tapley.

Mr. Kimber was replaced as Chairman of the Committee by Mr. G. E. Grundy, F.C.A., Superintendent of Insurance of Ontario and a member of the Ontario Securities Commission. Members of the Committee are Messrs. Louis de B. Gravel, Q.C., Director of the Legal Branch, Secretariat of the Province, Province of Quebec; W.S. Irwin, Superintendent of Brokers, British Columbia Securities Commission; Marc Lalonde, Q.C., Principal Secretary to the Prime Minister of Canada; K.P. Lawton, Q.C., Departmental Legal Adviser to the Department of the Provincial Secretary, Province of New Brunswick; and G.H. Rose, Q.C., Chairman of Alberta Securities Commission.

We recognized from the outset of our work that its successful completion required the collection of extensive and accurate information concerning the mutual fund and investment contract industries. "Information" is here used in a broad sense; we regarded the advice and opinions of experienced participants in the industries concerned as of importance at least equal to statistical information. We decided not to hold public hearings because we believed that greater benefit could be obtained from the submission of written briefs, from personal interviews and meetings, and from replies to questionnaires. This decision was supported by members of the mutual fund and investment contract industries with whom we discussed it, particularly since many of them were concerned that the publicity which would result from public hearings might adversely affect their operations.

In accordance with our decision to seek out those affected by our work rather than ask them to attend public hearings, we published a press release and wrote about 250 letters requesting the submission of briefs. A large number of submissions were received, many of them in letter form and many of

them confidential. In Appendix "F" we list the organizations which prepared the more extensive formal briefs, but we are equally indebted to the many others which commented in different ways on the matters before us. The most detailed brief was that of the Canadian Mutual Funds Association, which retained a research staff to prepare an extensive survey of the mutual fund industry. Unfortunately the final document was not received until the preparation of this report was almost complete. Quotations in the report are therefore taken from earlier drafts of papers in the C.M.F.A. brief, copies of which were given to us prior to the completion of the entire document. This accounts for the lack in the report of references to the page numbers in the brief at which the quotations appear.

We and our staff have had a very large number of meetings with representatives of banks, life insurance companies, mutual funds and trust companies across Canada and in the United States. We have benefited greatly from these meetings. Many were devoted to detailed reviews of questionnaires which we distributed to mutual funds and investment contract companies to obtain extensive information concerning their operations. Almost all recipients of these questionnaires prepared detailed replies; the single major exception is noted below. The information contained in the replies was supplemented by further extensive personal interviews.

Throughout our work a very high degree of co-operation has been extended to us not only by the mutual fund and investment contract companies, but by every organization with which we had occasion to deal. We do not believe the absence of public hearings has in any way inhibited the comments made to us. Without the unstinting co-operation of the organizations concerned, our work would have been much more difficult. The Canadian Mutual Funds Association and its staff made a particularly valuable contribution on behalf of its members.

To encourage freedom of communication we made representations to those from whom we obtained information that the confidentiality of non-public material would be respected, except to the extent necessary for the preparation of this report. Those representations assisted in the collection of data,

although they have limited the extent to which we could publish the information so collected. We have, however, been careful not to rely on a statement critical of an individual or group without endeavouring to obtain the relevant facts from the individual or group concerned.

Late in the course of our work problems arose involving a financial complex with headquarters in Vancouver. This complex includes two mutual funds, Diversified Income Shares Series A and Series B as well as an investment contract company, Commonwealth Savings Plan Ltd. These mutual funds and the investment contract company were the only large Canadian organizations which had refused to reply to questionnaires distributed by us. The Committee lacked powers of compulsion, and our efforts to obtain information concerning this group had been completely unsuccessful. Companies in the complex encountered severe financial problems, extending in some cases to bankruptcy or receivership. While we have not attempted to assess fault in this incident, we have followed developments with interest to ascertain what light they cast on matters being considered by us.

We have made extensive use throughout our studies of the legislative and the administrative experience in the United States, and have drawn on it in the formulation of many of our recommendations. Of particular importance is the Investment Company Act of 1940 (1940 Act), a federal statute which applies to mutual funds and investment contract companies as well as to other types of investment companies. Frequent references are made in the report to that Act and to the experience under it as indicated by our studies and by reports published by or under the authority of the Securities and Exchange Commission. The most important such study, published in 1966, was the Report on Public Policy Implications of Investment Company Growth.

We have been conscious of the fact that the 1940 Act contains provisions which have a major substantive impact on the internal operations of investment companies in the United States. The scope of these provisions is so wide as to make it of crucial importance to ensure that they are properly applicable in the Canadian economic and political environment before recommending their adoption here. Our analysis led to some recommendations which

differ fundamentally from the comparable 1940 Act provisions, and to a number of other recommendations which differ in detail. Complete explanations of the differences would require a considerable amount of space. Largely for this reson, we make reference in this report to the provisions of the 1940 Act and of other foreign legislation only where helpful to explain or illustrate our recommendations.

During the course of our studies we had the assistance of many persons without whose help these studies would not have been possible. Members of our staff made a major contribution both in the administrative activities, and in the formulation of policy on problems being considered by us. We were also assisted by consultants who were retained to undertake research on specific projects of special importance to our work. The number of those who helped in one capacity or another in the preparation of our report has prevented us from mentioning them all in the preface. Their names and a brief description of their work are given in Appendix "A".

The work of our staff and consultants was directed and co-ordinated by a few key individuals who deserve a special mention here. Mr. Hugh Cleland took an active role in all aspects of our work, but accepted particular responsibility for the preparation of a report on the trading practices of mutual funds. Mr. Douglas Pittet participated in the work of the sub-committee on non-financial disclosure in addition to discharging his principal responsibility in the contribution of advice concerning matters relating to the regulation of life insurance companies. Mr. Paul Dyson headed our research staff in the preparation of statistical and other information for us, and made a valuable contribution in the formulation of recommendations. The enthusiastic work of these three staff members was of great value to us.

Among the first acts of the Committee were the appointment of Mr. James C. Baillie as Director and Mr. Claude Bruneau as Associate Director of the study. These gentlemen made an excellent team and in the Committee's opinion, have done an outstanding job in organizing the study. They, with the help of senior research staff and consultants, have been responsible for analyzing, interpreting and otherwise preparing the information gathered for consideration

and the formulation of policy by the Committee at our regular meetings which have been held at approximately monthly intervals. They have then prepared drafts of chapters containing recommendations to reflect these policy decisions for revision where necessary and final approval by the Committee. Our thanks and appreciation are due to both Mr. Baillie and Mr. Bruneau for their devotion and fine work, and to the firm of Tory, Tory, DesLauriers and Binnington through whose kindness Mr. Baillie was able to participate in our work.

The nature of the Committee as a body reporting to, and financed by, eleven governments necessitated the resolution of many problems from an administrative standpoint. The Government of Ontario assumed responsibility to manage the accounts of the Committee and otherwise to participate in the administrative aspects of our work on behalf of all the governments concerned. It paid our disbursements and collected payment from the other governments for their portion. Without its assistance our task would have been far more difficult. We are particularly grateful to Messrs. A.V. Godden and R. Kroppmanns who willingly performed this extra work and were of great help to us and to our staff throughout.

We also thank the Department of Consumer and Corporate Affairs in Ottawa which has lent us its full support in organizing the translation of the report and its publication through the Queen's Printer (Canada). We were thus able to expedite its publication while reducing our cost.

Entire responsibility for the report and the recommendations therein is ours.

Gordon E. Grundy
Louis de B. Gravel
William S. Irwin
Marc Lalonde
Kenneth P. Lawton
G. Harry Rose

INTRODUCTORY NOTE

This report is divided into five parts. Chapters I to IV contain a description of the Canadian mutual fund industry, which includes many factual conclusions that form the basis of recommendations in subsequent chapters. Chapters V to XVI contain our recommendations concerning the regulation of mutual funds. A number of these recommendations are also applicable to investment contract companies, but the differences between investment contract, companies and mutual funds necessitated their separate discussion. Chapter XVII describes investment contracts and the investment contract industry; like chapters I to IV, it includes a number of factual conclusions that form the basis of subsequent recommendations. Chapter XVIII contains our recommendations concerning the regulation of investment contracts and the investment contract industry. Both Chapter XVII and Chapter XVIII incorporate by reference a number of relevant portions in the discussion of mutual funds. Finally, Chapter XIX considers problems which will arise in the implementation of our recommendations, with particular reference to the problems of divided jurisdiction in their administration.

Throughout this report, references are made to the responsibilities of the administrator. The neutral word "administrator" is used to avoid any implication as to what level of government, or what governmental agency within a particular level of governement, will assume responsibility for the administration of the regulatory scheme. These questions are discussed in Chapter XIX.

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CHAPTER I

DEVELOPMENT AND REGULATION OF MUTUAL FUNDS

1.01 Throughout our study of the Canadian mutual fund industry we have constantly been impressed by the degree of flexibility of the mutual fund as a form of organization, and by the dynamic way in which the financial community has made use of it to create new instruments shaped to fit the needs of investors. Significant benefits can result from these innovations, and care should be taken not to place undue legislative restrictions on mutual funds which will prevent further innovations in the future. To arrive at recommendations for legislation that would allow for continued adaptation and innovation while providing an adequate regulatory structure within which the industry could develop, we have found it necessary to work from the basic concepts that underly the mutual fund as a form of organization. Here and throughout this report we use the term mutual fund in its generally accepted sense as excluding closed-end investment companies.

1.02 The essential characteristic of all mutual funds is that they are vehicles to facilitate the pooling of money which belongs to a number of investors for investment as a single portfolio, with losses and gains experienced by the portfolio being passed through to the participants. The needs and objectives of particular types of investors are reflected in a variety of forms of organization and methods of operation, but all share this characteristic. We return to it in our discussion of the more technical definition of a mutual fund recommended in Chapter V.

1.03 Because we are dealing with a flourishing industry with established procedures, it is necessary that recommendations give full weight not only to the preservation of flexibility for future developments, but also to the existing position of the industry. This and the next three chapters are devoted to a general description of that position to provide the context within which our recommendations must be placed. In the remainder of this chapter we review briefly the organization and development of mutual funds, with specific examples. We also discuss the development by other financial institutions of instruments competitive with mutual funds. The chapter concludes with a description of the sources of controls, formal and informal, to which the mutual fund industry is presently subject.

Organization of Mutual Funds

1.04 The differences among mutual funds extend to their legal forms of organization: we comment later in this chapter, and frequently throughout this report, on the differences between mutual funds established as trusts and those which are incorporated. In spite of this, the general characteristic referred to in paragraph 1.02, together with the fact that the operation of a mutual fund is a commercial enterprise has resulted in some important organizational and operational similarities that are true of almost all mutual funds, trusteed or incorporated. This is because of the necessity to provide a means whereby the organizers may receive entrepreneurial rewards although profits and losses on the portfolio are passed through to public participants. Because many of the recommendations made in this report are designed to resolve problems which relate to the mutual fund as a commercial enterprise, we conclude in Chapter V that the term should be so defined as to exclude organizations that are merely investment clubs.

1.05 In other financial institutions, portfolio profits and losses are not passed through to participants. Most institutions, which include banks, insurance companies, investment contract companies and trust companies, raise money largely through the issuance of debt instruments that carry fixed rates of return. The organizer obtains his entrepreneurial reward principally through ownership of equity securities issued by the institution. Such

securities receive the benefit of earnings on the portfolio of the financial institution in excess of what is required to provide the promised return under the debt instruments and to pay expenses. This arrangement is not feasible in the context of mutual funds because of the necessity to pass profits and losses through to participants.

1.06 Traditionally, mutual fund organizers derive their reward from two sources: compensation for administration and investment management, and profit on the distribution of shares or units in the mutual fund. In order that such rewards may take the form of entrepreneurial profit rather than of salary, the organizers cause the administration and investment management of the mutual fund, and the distribution of its shares or units, to be carried on by outside organizations in which the organizers or their successors hold the equity participation. In some cases, all or a part of that equity participation may be sold to the public, with the proceeds of the sale enuring to the organizers. The legal form of the delegation to these outside organizations varies, particularly between incorporated mutual funds and trusteed mutual funds, but the results are identical for practical purposes. While in many cases the functions are performed by a single organization, for purposes of convenience in this report we usually refer to the organization that performs the administration and investment management as the "management company" and to the organization that distributes shares or units as the "distribution company"; it is important to realize throughout this discussion that the two companies are frequently the same.

1.07 The method of organization described in the preceding paragraph, which is almost universal in the Canadian mutual fund industry, has another advantage in addition to the fact that it facilitates the receipt of an entrepreneurial reward. In many cases, the mutual fund is organized not as an independent business enterprise but to be carried on in conjunction with other enterprises. In such cases, the responsible persons often do not devote their full time to the operations of the mutual fund and it would be difficult for them to be compensated by salary. Even where they are engaged on a full-time basis in mutual fund operations, they may be responsible for several mutual

funds with different investment objectives organized to appeal to a wide variety of investors. Any other arrangement than delegation of the administration, management and distribution functions would cause considerable difficulty and inconvenience in this and other situations. It is for these reasons that delegation of these functions is almost universal in the Canadian mutual fund industry, although theoretically a mutual fund could be organized in which the functions were internalized and performed by employees. A few mutual funds in the United States have been so organized.*

1.08 When considered in the context of their relationship with other financial institutions, major differences exist among mutual funds. Some are organized as incidental parts of the operations of financial institutions primarily engaged in other activities; others form parts of financial complexes; yet others are created by organizations devoted exclusively or primarily to the operation of mutual funds. An understanding of these different situations is essential to an understanding of the Canadian mutual fund industry. They are considered in the following section.

Relationships of Mutual Funds to Other Financial Institutions

1.09 Examples abound of mutual funds organized to be operated in conjunction with other enterprises. Many brokerage firms have found it an effective way to satisfy the needs of clients who wish their money to be managed on a discretionary basis by the brokerage firm. Administration and other expenses make such management uneconomic unless the amount of money involved is substantial; through the mutual fund vehicle, contributions from a number of clients may be pooled for investment as a single portfolio. One mutual fund, First Harfund Limited, was organized by a brokerage firm to provide for the portion of its clients' discretionary accounts that was to be invested in securities of United States companies. In such cases, the brokerage firm acts both as the management company and the distribution company. The mutual fund often forms

* The largest of the internally managed mutual funds, Massachussetts Investors Trust, had assets of $2.375 billion at the end of 1968. For a discussion of the organization of this mutual fund, see Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, House Report 2337, 89th Cong. 2nd sess., 1966, at pp. 49 and 105 (hereinafter referred to as "Public Policy Report").

a comparatively minor part of the business activities carried on by the brokerage firm, which considers it simply as an additional service for its clients, although investors in the mutual fund may include persons who are not otherwise clients of the brokerage firm.

1.10 Considerations similar or identical to those applicable with respect to brokerage firms have also motivated other financial institutions to organize or to participate in the organization of mutual funds. At the time of writing, three Canadian chartered banks are in a position to arrange investments by their clients in mutual funds that are directly or indirectly associated with the banks; the nature of these arrangements is discussed in paragraphs 16.07 to 16.28. At the end of 1968, some 20 trust companies were offering investment funds for public participation; in paragraphs 5.20 to 5.36, we explain the reasons for our conclusion that these investment funds should be regarded as mutual funds for regulatory purposes. Some banks and trust companies regard the mutual fund as an additional service to existing clients, while others have engaged in sales campaigns to attract purchasers from a wider circle of investors.

1.11 A tendency towards development of Canadian financial complexes has become increasingly marked in recent years. The complexes differ in approach from a brokerage firm, bank or trust company that creates a mutual fund to offer an additional service to clients. They consist, rather, of a number of financial institutions, each concentrating upon a different type of financial service. Almost invariably, they include at least one mutual fund, which may be separate from the other financial institutions that form part of the complex but is more usually operated in conjunction with one or more of them.

1.12 The development of financial complexes is well illustrated by reference to The Investors Group and its associated companies. It is the successor of Investors Syndicate of Canada, Limited, which was incorporated in 1940 by a special Act of the Manitoba legislature to take over the Canadian business of the parent company, Investors Diversified Services, Inc. of Minneapolis, Minnesota. The business at that time consisted exclusively of the sale of investment contracts. In 1950, Investors Syndicate of Canada, Limited

organized an incorporated mutual fund called Investors Mutual of Canada Ltd., for which Investors Syndicate of Canada, Limited acted as management company and distribution company. At the end of 1968, the total net assets of Investors Mutual of Canada Ltd. were $584,818,616.

1.13 In 1956, Investors Diversified Services, Inc. divested itself of its Canadian subsidiary through the distribution of a stock dividend in shares of Investors Syndicate of Canada, Limited. The latter company was reorganized in 1964 and is now called The Investors Group. Its control is held in Canada, and it is operated separately from Investors Diversified Services, Inc. The Investors Group is a public company, listed on Canadian stock exchanges.

1.14 Concurrently with the reorganization of Investors Syndicate of Canada, Limited as The Investors Group, a new subsidiary was incorporated with the name Investors Syndicate Limited. The latter carries on the sale of investment contracts and also acts as distribution company for Investors Mutual of Canada Ltd., Investors Growth Fund of Canada Ltd., and Investors International Mutual Fund Ltd. The Investors Group is the management company of these three mutual funds. The latter two mutual funds were incorporated in 1957 and 1961 respectively to provide a greater variety of investment objectives for potential purchasers; their aggregate total net assets at December 31, 1968 were $441,281,474. The three mutual funds together formed the largest mutual fund complex in Canada at that date. Salesmen of Investors Syndicate Limited sell its investment contracts and shares of the three mutual funds. In addition, they can provide their customers with information as to other services offered by The Investors Group and its subsidiary companies.

1.15 The Investors Group has other financial interests. It owns The Western Savings and Loan Association, a company which, like Investors Syndicate Limited, issues investment contracts and acts as distribution company for mutual funds (Provident Mutual Fund Ltd. and Provident Stock Fund Ltd.) of which The Investors Group is the management company. These two mutual funds had aggregate total net assets at the end of 1968 of $42,996,574 so that the aggregate total net assets at that time of mutual funds managed by The

Investors Group was $1,069,096,064. The Investors Group carries on trust company operations through Investors Group Trust Co. Ltd., and also has subsidiaries engaged in real estate development and other activities. In addition, The Investors Group has substantial interests in a number of other Canadian public companies.

1.16 The development of Canadian financial complexes is further illustrated by the fact that during the period of our study The Investors Group has itself been absorbed into a large financial complex that covers a wide gamut of Canada's economic and financial life. Based on a closed-end investment company, Power Corporation of Canada, Limited, this complex controls or is associated with other mutual funds, life insurance companies, and a major trust company. The Great-West Life Assurance Company, of which The Investors Group acquired control shortly prior to the time of writing and which has a substantial interest in The Investors Group, is active in the development of variable insurance contracts, discussed in paragraphs 5.37 to 5.47 below. Montreal Trust Company, in which both Power Corporation of Canada, Limited and The Investors Group have substantial interests, offers investment funds for public participation which had aggregate total net assets of $30,724,241 at the end of 1968. The Royal Bank of Canada, which has interests in both Montreal Trust Company and The Investors Group, is associated in the manner described in paragraphs 16.10 and 16.11 with RoyFund Ltd., a mutual fund first sold to the public during 1967, with total net assets at the end of 1968 of $9,811,064. These are only some of the organizations associated with the complex which offer mutual fund shares or units or competitive instruments, and almost every other type of financial service is provided by at least one company in the complex.

1.17 In addition to mutual funds organized by other financial institutions, and those which form part of financial complexes, there are many instances in which organizations have been established specifically to operate mutual funds. The most important example, and the second largest mutual fund organization in Canada, is United Funds Management Ltd. Like the predecessor company of The Investors Group, this company was organized by a major United

States mutual fund organization. While a small proportion of the shares of United Funds Management Ltd. has been sold to the public, that organization, Waddell & Reed, Inc., continues to own in excess of 74% of the outstanding shares at the time of writing. United Funds Management Ltd. acts as management company for mutual funds with aggregate total net assets at December 31, 1968 of $523,286,871. Two wholly-owned subsidiary companies of United Funds Management Ltd., United Investment Services Ltd., and United Investment Services (Quebec) Ltd. together act as distribution companies for these mutual funds. It is of interest that United Funds Management Ltd. arranged in 1968 for the incorporation of United Investment Life Assurance Company, a subsidiary designed to carry on the life insurance business.

1.18 Frequent references are made in this report to the Investors and the United groups as representative of the structure of mutual fund organizations. The two groups are illustrative of the variety in Canadian financial institutions, and of the increasing emphasis on and growth of mutual funds and instruments competitive with them during recent years. Yet even these examples do not adequately represent the diversity of the industry. In the next section we discuss the growth of the mutual fund industry and the important development by other financial institutions of instruments for sale to the public that are directly competitive with mutual funds, yet are not mutual fund shares or units within the usual meaning of those terms.

Growth of Mutual Funds

1.19 The major growth of the Canadian mutual fund industry has occurred within a remarkably short period of time. Prior to the depression of the 1930's closed-end investment companies were very popular, in Canada as in the United States;* in paragraph 5.05 we comment on the precise distinction between these organizations and mutual funds, but for present purposes this can be more briefly stated. The holder of shares issued by a closed-end investment company cannot require that they be accepted for surrender; partly as a consequence of the resultant potential discrepancy between market price and issue price, very few closed-end investment companies have ever engaged in continuous

* For an interesting history of the development of the mutual fund industry, see Bullock, The Story of Investment Companies (1959).

distributions of their shares to the public. Secondly, many closed-end investment companies, particularly prior to 1930, had issued senior classes of securities in large amounts, for purposes of leverage. The latter factor accentuated the losses suffered by equity participants in the depression, losses which were so great that closed-end investment companies have been comparatively unimportant in the United States ever since.

1.20 The consequences of the depression of the 1930's for equity participants of Canadian closed-end investment companies were not, generally speaking, as catastrophic as was true in the United States. This may in part account for the fact that, proportionate to the mutual fund industry, closed-end investment companies are now somewhat larger in Canada than in the United States. The difference is not great: in Canada, aggregate assets of closed-end investment companies at the end of 1967 were approximately $768 million an amount equal to about 28.8%* of the total net assets of Canadian-organized mutual funds being sold to Canadians at that date. The corresponding proportion in the United States at the end of September 1968 was 7.8%. While it is clear that the mutual fund industry is far larger in each country, there is no reason to believe that closed-end investment companies cannot still be successful in Canada. This means that many activities prohibited for mutual funds could still be carried on by closed-end investment companies. In this report, we recommend certain restrictions on the operations of mutual funds that we believe to be dictated by their method of operation. It is important that implementation of our recommendations would, in most cases, not prohibit such activities for all investment companies; closed-end companies could still engage in them. This is particularly true with respect to investment restrictions, discussed in Chapter XII.

1.21 While the two major Canadian mutual funds in 1940, Canadian Investment Fund, Ltd. and Commonwealth International Corporation Limited, had total net assets of approximately $7.5 million in that year, the mutual fund industry in Canada did not begin its period of really rapid growth until the

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* Dominion Bureau of Statistics, Business Financial Statistics Balance Sheets, Selected Financial Institutions, Fourth Quarter 1967, Ottawa: Queen's Printer, May 1968, Table 5A, p.10. Assets are given at market value.

mid-1950's. Complete figures for the period are not available but at the end of 1950 total net assets of Canadian mutual funds qualified for sale in Canada aggregated approximately $46 million, and the corresponding figure at the end of 1961, inclusive of trust company investment funds, was $795 million. From that time to the time of writing, assets have continued to increase at a rapid rate with only a few respites, as public interest in equities has grown and as the number of entrants to the mutual fund industry has increased. At the end of 1967, aggregate total net assets of investment funds offered for public participation by trust companies was approximately $158 million; the value of shares held by Canadians in United States mutual funds qualified for sale in Canada was approximately $104 million; and the total net assets of Canadian mutual funds qualified for sale in Canada was approximately $2,508 million, for a total of $2,770 million. The number of participants shows a correspondingly rapid increase. At the end of 1967, there were 118 organizations qualified as mutual funds for sale in one or more provinces of Canada; the approximate subdivision of this figure was 19 investment funds offered by trust companies, 12 United States mutual funds and 87 Canadian mutual funds. By the end of 1968, the number qualified had risen to 136, subdivided into 20, 19 and 97 in the three categories respectively.

1.22 During the period since 1957, the growth rate of mutual funds has exceeded the growth rate of other financial institutions. This growth rate owes much to the effective distribution techniques developed by distribution companies, but could not have occurred without increasing public interest in equity investments, and acceptance of mutual funds as the principal financial intermediary for such investment. It was inevitable that the success of the mutual fund industry, coupled with the increasing public demand for equity investments, should attract other financial institutions into the market. This tendency was emphasized by the trend toward increased competition among financial institutions, a trend encouraged by government.* In the following section

* See Bank Act, S.C. 1966-67, c.87, for a good example of governmental encouragement of competition. The statute implemented many recommendations of a Royal Commission which were designed to foster competition among the chartered banks. (Royal Commission on Banking and Finance, Report, Ottawa: Queen's Printer, 1964).

we review in summary form the most important developments on the part of other institutions that are relevant to this report. In Chapter V we make recommendations as to the institutions which should be subject to regulatory schemes similar to those applicable to mutual funds, but the discussion in the following section is not restricted to such institutions.

Growth of Competition Between Mutual Funds and Other Financial Institutions

1.23 The most convenient starting point for an analysis of developments in other financial institutions leading to the issuance by them of instruments competitive with mutual funds is 1942, when the Income War Tax Act was amended* to introduce favourable tax treatment of money contributed to pension funds. Details are not necessary for present purposes, especially since the legislation has been amended several times since. Its principle has remained the same. It is simply the postponement of tax on money contributed to pension funds, so that such money is taxed as income to the payer in the year of distribution rather than in the year in which it was contributed; it can, then, be deducted from taxable income in the year of contribution. Conditions, including restrictions on the amount deductible in any one year, are attached to the provisions but they nonetheless provide significant tax advantages. These provisions have been one of the principal factors responsible for the growth in market value of assets of trusteed pension funds from $4.1 billion at the end of 1961 to $7.9 billion at the end of 1967, representing an increase of 92.5%.**

1.24 Trust companies and life insurance companies are the financial institutions which are the principal competitors for the business of administering pension funds and when interest in equity investments began to develop, the trust companies found that they were in an advantageous position because they had power to administer pension funds with portfolios invested in equities. The life insurance companies were prevented from doing so by reason of statutory restrictions on their investment policies. This difference between the regulatory treatment of the two types of financial institutions was largely

* An Act to amend The Income War Tax Act, S.C. 1942-43, c. 28.

**Dominion Bureau of Statistics, Trusteed Pension Plans Financial Statistics, 1967, Ottawa: Queen's Printer, November 1968, p.11.

resolved in 1961 by the addition to the relevant federal legislation of an enabling provision; corresponding provisions have since been added to the Insurance Acts of several provinces.*

1.25 The life insurance companies quickly took advantage of the 1961 amendments thereby adding to the growth of equity investments by pension funds. By the end of 1967, market value of equity investments by Canadian trusteed pension funds, including those administered by life insurance companies, trust companies and others, was in excess of $1.8 billion. Canadian trusteed pension funds had 12% of their total assets invested in equities in 1960, and 23.2% in 1967.**

1.26 Further developments in the pension area leading to the issuance of instruments bearing closer resemblances to mutual fund shares or units evolved shortly after the passage of amendments to the Income Tax Act in 1957, which introduced the predecessor of the present section 79B. The purpose of this provision is to grant tax advantages for registered retirement savings plans established by individuals, so that an individual making no use or not making full use of the tax deductions available for contribution to pension funds can obtain similar advantages by establishing such a plan: Shortly after the passage of these amendments, several Canadian trust companies organized special investment funds catering to registered retirement savings plans to enable their clients to take advantage of the new provisions. Most trust companies organized two or more such funds, to provide a choice between a portfolio which concentrates on equities and portfolios with other investment objectives, but the funds investing in equities have proved to be the most popular. By the end of 1967, the equity investments of these funds aggregated in excess of $62 million. While these funds are very similar to mutual funds

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* The federal legislation is: The Canadian and British Insurance Companies Act, R.S.C. 1952, c.31, s.81, as am. S.C. 1960-61, c.13, s.16; Foreign Insurance Companies Act, R.S.C. 1952, c.125, s.37, as am. S.C. 1960-61, c.16, s.4. The provincial legislation is: The Alberta Insurance Act, R.S.A. 1955, c.159, s.100, as am. S.A. 1967, c.40, s.3; The Insurance Act, R.S.O. 1960, c.190, s.80, as am. S.O. 1961-62, c.63, s.3; The Insurance Act, R.S.B.C. 1960, c.197, s.107, as am. S.B.C. 1963, c.19, s.4.

** Dominion Bureau of Statistics, Trusteed Pension Plans Financial Statistics, 1967, Ottawa: Queen's Printer, November 1968, p.11.

in a number of ways, we have concluded for the reasons set out in paragraphs 5.33 to 5.35 that they should not be treated as mutual funds for regulatory purposes.

1.27 After a period of experiment with the operation of registered retirement savings plans, several trust companies expanded their range of services to include funds in which clients wishing portfolio management could invest their money and from which they could withdraw at any time. For many years, the trust companies had provided portfolio management on an individual basis to meet the needs of larger clients and one of the objectives of the new funds was to provide similar services to clients with smaller amounts of money available for investment. Here, as with funds for registered retirement savings plans, most of the trust companies organized two or more funds to provide clients with a choice of investment objectives; again as with funds for registered retirement savings plans, the equity-oriented funds have been proven most popular. Since the first major trust company investment fund was created by The Canada Trust Company in 1959, investments in the equity sections of this and other such funds have grown to over $87 million (at the end of 1967); we obtained detailed information from 14 trust companies offering these funds during 1967 and are aware of the existence of about five more offered by small trust companies. As stated in paragraph 5.32, we have concluded that a unit in such an investment fund plays a role in the portfolio of the investor which is virtually identical to that played by the share or unit issued by the organizations traditionally known as mutual funds, and that they should be subjected to a similar regulatory scheme.

1.28 The 1961 amendments to the federal legislation governing life insurance companies were designed to enable the companies to set up segregated funds to which some of the investment restrictions ordinarily applicable to life insurance company investments would be inapplicable and which were therefore able to invest heavily in equities. While it was assumed at the time the amendments were passed that the life insurance industry would make use of

them only in connection with group life insurance and pension arrangements* they were not so restricted. In result, they gave life insurance companies subject to the federal legislation the power to issue on an individual basis policies under which a portion of the benefits payable is computed by reference to the value of a proportionate interest in a segregated fund. By the end of 1967 about a dozen companies had exercised this power or similar powers granted under provincial legislation to issue such policies, referred to in this report as individual variable policies. Many of these policies are designed to enable the policyholder to take advantage of the special tax concessions for registered retirement savings plans, but others simply provide an equity feature in an otherwise conventional life insurance policy.

1.29 The individual variable policy aspect of the life insurance industry is still comparatively small, but it seems reasonable to anticipate rapid growth in this area. Premiums paid to life insurance companies for variable contracts in 1967 amounted to about $49,250,000, representing about 3% of total premiums paid for life insurance and annuities; $49 million of the total was for group contracts, so that total premiums for individual variable contracts were about $250,000.** The assets in group and individual variable funds at the end of 1967 represented about $197 million. Individual variable contracts are dealt with in more detail in Chapter V, which also considers the extent of their similarity to mutual funds.

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* In his testimony before the Standing Committee on Banking and Commerce, the then Superintendent of Insurance, Mr. K.R. MacGregor said:

> As I see the situation, it might be summarized in this way; the great majority of all Canadian life companies want to be in a position to compete better with the trust companies in the group pension field, and their present thinking and intention, as I understand it, is that the investment restrictions up to the time a person reaches pension age should be relaxed, not as respects quality, but as respects particularly the proportion that may be put into common stocks. At the moment their present thinking is that when the pension arrives the employee's equity would be to purchase an annuity at a fixed dollar amount in the regular funds of the company. It may be nevertheless, that as time goes on they will want to go further and provide for the payment of a variable sum. The proposed amendment would permit it; I must admit that.

Senate Hearings, Proceedings of the Standing Committee on Banking and Commerce, Wednesday, February 8, 1961.

** The Canadian Life Insurance Association, Submission to the Canadian Committee on Mutual Funds and Investment Contracts, (Toronto: The Canadian Life Insurance Association, June 1968), p.9.

1.30 Other financial institutions have also become involved in the market for financial instruments representing equity participations. Earlier in this chapter we refer to the three chartered banks that are associated with mutual funds; the nature of their relationships is discussed in greater detail in Chapter XVI. One credit union, Ontario Co-operative Credit Society, organized a mutual fund, Landmark Growth Fund Limited, in 1965. The Caisses Populaires Desjardins de la province de Québec and Quebec Trust Company distribute shares of an associated mutual fund, Le Fonds Desjardins. It seems reasonable to anticipate that the tendency toward increasing involvement by other financial institutions in this market will increase.

1.31 The developments outlined above have been accompanied by a movement on the part of some mutual fund organizations into fields formerly occupied by other financial institutions. As might be expected, this tendency is particularly pronounced with organizations which were established solely to operate mutual funds and are not part of another financial institution or financial complex. Such organizations are exemplified in paragraphs 1.17 and 1.18 by United Funds Management Ltd., which has organized United Pension Fund Ltd. as a mutual fund designed to appeal as an investment to pension funds. It has also, as mentioned in paragraph 1.17, organized a life insurance company. Similar steps have been taken or are being considered by other mutual fund organizations.

1.32 The most important constraint on competition between life insurance and mutual fund organizations is the fact that under existing policies of Superintendents of Insurance in most Canadian provinces (policies supported, at least in past years, by most of the major life insurance companies) a salesman cannot become qualified to sell on a commission basis both mutual fund shares or units and life insurance policies. The mutual fund industry has long pressed for a change in this approach; we have concluded that the policy against dual licensing is unduly restrictive, and changes are recommended in paragraphs 14.26 to 14.35. In the meantime, the competitive position has resulted in arrangements whereby mutual fund salesmen distribute completion insurance on contractual plans for the purchase of mutual fund shares or units, under

arrangements with life insurance companies although they are usually unable to collect commission on the life insurance element of such sales. In one study done by us of a total of 194,236 contractual plans (i.e., periodic payment plans under which the salesman is compensated through the use of a front-end load) for the purchase of shares or units in Canadian mutual funds which were outstanding in 1967, we found that 32,959 or 16.97% had been sold with completion insurance.

1.33 The developments outlined in this section may be summarized as great growth in the use of financial instruments which represent equity participations, accompanied by increasing competition among financial institutions to profit from that growth. Much of the remainder of this report is devoted to discussions of the implications of these developments, and to specific recommendations for controls designed to ensure that they serve the public interest without being unduly restricted by governmental regulation. We discuss in the next section the nature and content of the existing regulatory structure applicable to mutual funds; no attempt is made to describe that applicable to other financial institutions competitive with mutual funds.

Existing Regulation of Canadian Mutual Funds

1.34 With minor exceptions noted in the following discussion, no Canadian jurisdiction has enacted legislation specifically to govern the operations of mutual funds. For reasons indicated throughout this report, we feel that such legislation should be enacted, but it must take cognizance of the regulatory environment within which the industry now operates. The environment is also of importance because it has had a major effect on the structure and operations of the mutual fund industry as it presently operates in Canada. In the absence of legislation tailored to their needs, mutual fund organizations have had to fit within regulations which impose on them requirements that are frequently ill-adapted to them.

1.35 Another difficulty with the present regulatory position is that instruments competitive with mutual funds are not subject to the same regulations. This must put one or the other at a competitive disadvantage. Steps

have been taken to remedy the situation; for instance, in several provinces trust company investment funds are subject to securities legislation in the distribution of their units, and the Superintendents of Insurance in several provinces have imposed requirements with respect to the sale of variable life insurance policies that are similar to those applicable on the sale of mutual fund shares or units. Implementation of our recommendations would substantially increase the uniformity in applicable requirements.

1.36 There are four principal sources of constraints applicable to mutual funds. Unquestionably the most important is the securities legislation of the Canadian provinces, designed for application to all distributions of securities and to persons trading in securities. Secondly, provisions are applicable by virtue of the form of organization of the mutual fund; company law to incorporated mutual funds, trust law to unincorporated mutual funds. As the following discussion makes clear, there are very considerable differences in these provisions and one of the objectives of recommendations made in this report is to minimize the differences which flow from selection of the trusteed or the incorporated form of organization. Thirdly, income tax law imposes significant constraints. Fourthly, self-regulation by the mutual fund industry and the adoption by it of ethical standards have made a valuable contribution.

1.37 Many of the restrictions or constraints which result from the four regulatory sources outlined in the preceding paragraph overlap considerably, so that the separate discussions of the four sources in following subsections is to some extent misleading. The reader should bear in mind that regulations arising from the various sources frequently deal with the same question, sometimes in different ways.

(a) Requirements Imposed By or Under Securities Legislation

1.38 For purposes of analysis, it is convenient to divide the requirements imposed by securities legislation into those which are specifically set out in the relevant legislation, and those which are imposed by securities administrators on a discretionary basis in the application of the legislation.

1.39 The major emphasis of securities legislation is on the principle that organizations engaged in the distribution of securities to the public, and those whose securities are held by the public, should make full disclosure of relevant matters concerning their affairs. So far as mutual funds are concerned, the most important requirements applied to carry out this principle are that a prospectus be filed with respect to the mutual fund shares or units while they are being distributed to the public, and that a copy of the prospectus be delivered to each purchaser. We will not review here the contents of the prospectus, which are considered in Appendix "E". It is sufficient for present purposes to say that the prospectus is ordinarily a very detailed document containing extensive information as to the mutual fund, its operations, and the terms of sale of its shares or units. In Chapter XIV we express some doubts concerning the practical value of prospectuses as they are presently prepared, but they do provide extensive information on most matters which might be of interest to a purchaser.

1.40 The emphasis on disclosure is repeated in the securities acts of British Columbia, Alberta, Saskatchewan, Manitoba and Ontario by provisions dealing with continuing financial disclosure, proxy disclosure, and disclosure of insider trading. While these requirements are of very considerable importance with most public companies, they are less significant in the context of mutual funds. This is primarily because almost all mutual funds are continuously in the course of primary distribution of their securities to the public, and so must have a valid prospectus in effect at all times; this means that an amendment or new prospectus must be filed whenever a material change occurs, and in any event at least annually. The prospectus contains at least as much information as is ordinarily required to be disclosed under the provisions dealing with continuing financial disclosure and with proxy disclosure. As to the requirements concerning insider trading disclosure, we indicate in paragraphs 9.50 to 9.53 the reasons for our conclusions that these provisions are of little or no value in the mutual fund context. Finally, in most of the provinces mentioned above none of these provisions - financial disclosure, proxy disclosure, or insider trading disclosure - is applicable to unincorporated or trusteed mutual funds, although some comply on a voluntary basis.

1.41 The other principal statutory requirement applicable to mutual funds under the securities laws concerns the registration of persons trading in securities. In light of the separation of functions described in paragraphs 1.05 to 1.07 these provisions ordinarily apply not to the mutual fund itself but to the outside organization to which the mutual fund delegates the sales function - the distribution company. This organization must register with the securities administrators in provinces where the distribution is being effected, and is subject to the continuing supervision of those administrators while its registration remains effective. No similar requirement is applicable to the management company, so that in the case of mutual funds which delegate the management and the distribution functions to separate organizations, the distribution company is registered with the securities administrators but the management company is not.

1.42 It will be noted that both the prospectus requirement and the registration requirement are applicable only to mutual funds which are engaged in the distribution to the public of their shares or units. This means that the benefits provided by application of these provisions are not available with respect to mutual funds not currently distributing securities to the public. It also means that the discretionary powers of securities administrators, discussed in following paragraphs, are not operative with respect to mutual funds which are not distributing their securities. While the great majority of mutual funds do engage in such distributions on a continuous basis, there are some which do not; more importantly, a mutual fund may avoid the necessity of compliance with any of these requirements by ceasing to distribute securities and permitting its prospectus to become ineffective.

1.43 Perhaps of even greater importance to the industry than the requirements actually embodied in securities legislation are the requirements applied by administrators on a discretionary basis in the application of the legislation. For the most part, these requirements are imposed as preconditions to the acceptance for filing of the prospectus, although those responsible for the operations of mutual funds are so well aware of the availability of this sanction that it is only rarely articulated. In practice, the securities

administrator either enunciates a generally applicable policy ruling* or imposes a requirement to deal with an actual or potential problem in a specific case. Often, securities administrators will adopt policies on specific questions without reducing them to written form for purposes of publication, and may vary them somewhat from case to case. The latter approach provides greater flexibility in administration, but it also reduces the certainty of the law and makes it more difficult to obtain precise information on applicable requirements.

1.44 The requirements applied by securities administrators to mutual funds through the exercise of their discretionary powers as outlined above cover a wide range of situations. Perhaps the most obvious are those which relate to the charges that may be levied in connection with the distribution to the public of mutual fund shares or units, referred to as commission rates, loading charges or sales charges (the latter term is the one generally used in this report) and those which relate to the amount of compensation that may be paid to the management company. These questions are of great importance to mutual fund organizers, for (as noted in the discussion in paragraphs 1.05 to 1.07 of the reasons for separation from the mutual fund of the management and distribution functions) it is upon sales charges and management fees that they must rely to obtain their entrepreneurial reward.

1.45 Securities administrators have become involved in questions of the determination of sales charges and management fees because of the absence of genuine negotiation at arm's length in the determination of the basis upon which the management and distribution functions are delegated to outside organizations. With the possible exceptions of the rare cases where the mutual fund is an incorporated fund with a fully independent board of directors, the organizers are in a position to dictate the terms of the relevant document or documents. In the absence of controlling legislation, and to carry out their responsibility for the protection of the investor, the securities administrators have felt it necessary in the public interest to guard against the possibility that the mutual fund organizers might abuse their power in dictating the terms

* The February, 1968 policy ruling of the Ontario Securities Commission on management fees is an example of this type of ruling. Its full text is set out in paragraph 10.16.

of the management and sales arrangements. They have concluded that disclosure of sales charges and management fees is not enough, and that substantive controls are necessary for investor protection. The nature of the substantive controls imposed on sales charges and management fees, and our recommendations on these questions, are discussed in Chapter X.

1.46 While controls over sales charges and management fees have the greatest direct impact on the entrepreneurial rewards received by mutual fund managers, the rates set under these controls have become a part of the industry pattern and serious complaints concerning them are comparatively rare. Other requirements imposed by securities administrators, although of less importance, sometimes arouse more controversy in their application. Only a few examples of these policy requirements are given in following paragraphs. A complete review would be difficult or impossible, because their discretionary nature has enabled the administrators to devise or to adjust requirements to suit individual cases as they arise. In some instances, administrators in different provinces follow differing policies on particular questions.

1.47 Most administrators, who are in agreement with the majority of the industry on this point, believe that mutual funds should not be permitted to borrow money, to trade on margin, or to engage in short sales; all of these activities are considered to be speculative and inconsistent with the role of a mutual fund, and the administrators ordinarily require that the investment objectives of a mutual fund preclude their use. For different reasons, the administrators also restrict investment by mutual funds in assets incapable of ready liquidation or precise valuation; the feeling here is that such investments might prevent a mutual fund from carrying out its obligation to redeem its shares or units on demand of the holder. In Chapter XII, we indicate the reasons for our conclusion that all of these activities should be permitted, subject to appropriate limitations, but that certain restrictions should be imposed on the techniques used for the distribution of shares or units of funds which engage in them. A scheme such as we there recommend could not be applied by securities administrators exercising their discretionary power on a case-by-case basis; this is only one example of the difficulties in the existing method of control.

1.48 Another important investment restriction which administrators expect a mutual fund to adopt relates to the size of the maximum permissible investment in securities of any single company. This limitation is designed both to avoid liquidity problems in the disposal of the securities and to prevent the mutual fund from gaining control of a public company.

1.49 The Quebec Securities Commission, in addition to the requirements referred to above, prohibits mutual funds from purchasing on an initial distribution of securities unless the securities sold are themselves qualified in the province of Quebec, or transactions are consented to by the Quebec Securities Commission. It also imposes a number of other restrictions, including restrictions designed to avoid transactions entered into by the mutual fund with its associated companies.

(b) Requirements Imposed on Incorporated Mutual Funds by Company Law

1.50 Sixty-two of the 117 Canadian organized mutual funds qualified for sale to the Canadian public at December 31, 1968 were organized as companies. Each of these mutual funds is subject to the provisions of the corporations act in the jurisdiction of its incorporation, and to the extensive body of law applicable to companies. The only exceptions to the general law of companies which have been made for Canadian mutual funds are contained in provisions included in some corporations acts to enable mutual funds to issue shares redeemable on demand by the holder.

1.51 The reason that the issuance of shares redeemable on demand by the holder merits special discussion is that corporation law in Canada has followed the British pattern in prohibiting companies from the redemption of their common shares, and restricting the manner in which redemptions of preferred shares may be effected. Specific recommendations are made in paragraphs 5.62 to 5.64 for changes in the company law designed to adapt it to the mutual fund concept. For present purposes, it is sufficient to say that the shares sold to the public by most mutual funds incorporated in Canada are, technically, preferred shares rather than common shares and that the mutual

funds are incorporated only under the laws of jurisdictions (principally Canada, Ontario and Alberta) which permit the issuance of preferred shares redeemable on demand by the holder for net asset value. Only thus have mutual fund organizers been able to provide the essential attribute of redeemability on demand by the holder.

1.52 Company law includes a variety of protections and powers for shareholders, but many of these are extended only to holders of common shares. Thus, one result of the rules described above is that certain protections ordinarily extended to shareholders are not available to all shareholders of incorporated mutual funds. Perhaps the best example of this is the right to vote. In many incorporated mutual funds, the mutual fund shares do not carry power to vote for the election of directors. An underlying class of common shares, issued by the mutual fund to the organizers or their associates, carries power to elect the directors and enables the organizers to perpetuate their control. In some cases, the mutual fund shares are given the right to vote but control is perpetuated for the organizers through a specification that a director must hold a common share. The holders of mutual fund shares are thereby denied rights which are ordinarily regarded as being available to common shareholders, without receiving any of the compensating advantages ordinarily regarded as being available to preferred shareholders.

1.53 Another difficulty with the existing situation is that in many incorporated mutual funds there are restrictions as to the sources from which money may be taken for the redemption of shares. In certain circumstances, such restrictions could, in theory, prevent the mutual fund from effecting payment on redemption of shares. These restrictions are technical in nature, and detailed discussion of them is postponed to Chapter V.

1.54 Perhaps the most important requirements of company law in the mutual fund context, apart from those that relate to the redeemability of shares, are those which may affect the separation of the management and distribution functions from the mutual fund. A basic tenet of company law is that, in the words of the Canada Corporations Act, "The affairs of the company'

shall be managed by a board of directors however designated."* This requirement is seemingly inconsistent with the delegation of the vitally important management and distribution functions to an outside organization or organizations. Indeed, if those functions were fully delegated, the board of directors would be left with no responsibility. The law allows for no exception to the requirement that there be a board of directors and in practice the contracts entered into by the incorporated mutual fund with the management company and the distribution company always purport to reserve final authority to the directors. An example of the situation which can result when that authority is exercised is provided by the description of the Commonwealth-Channing proxy battle in paragraphs 6.13 to 6.30.

1.55 A number of other provisions of company law are relevant to mutual funds. Most corporations acts limit not only the sources of money that a company may use for redemption of shares, but also the sources of money for distribution as dividends. These restrictions are considered in paragraphs 5.67 to 5.72. There are various specific provisions dealing with the distribution of annual reports to shareholders and their content. Procedures on transfer of shares are spelled out, as is the nature of the records which must be maintained by the company. Generally, the corporations acts and the decided cases together provide a body of law which deals in considerable detail with almost all aspects of company-shareholder relationships. While some of the relevant provisions differ between jurisdictions, the subjects dealt with and the approach are comparatively uniform. In a few cases the provisions are not properly adapted to the distinctive characteristics of mutual funds, and recommendations on these points are made elsewhere in this report. In spite of these problems, and other problems alluded to above, the availability of this body of law does a great deal to make clear the position of the shareholders of incorporated mutual funds.

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* Canada Corporations Act, R.S.C. 1952, c.53, s.84 as am. S.C. 1964-65, c.52, s.34.

(c) Requirements Imposed on Unincorporated Mutual Funds by Trust Law

1.56 From a technical standpoint, the organization of an unincorporated mutual fund is very different from that of an incorporated mutual fund. The average investor is, we believe, unconscious of this fact; so far as he is concerned, there is no difference inherent in the distinction between the unit of an unincorporated fund and the share of an incorporated fund. Indeed, interests in some unincorporated funds are referred to as shares rather than as units so that even an investor who cares about such things may be mistaken as to the form of organization of his mutual fund.

1.57 While it is possible that an unincorporated mutual fund might be organized in another way, for example as a partnership, the invariable method in Canada where public distribution of units is contemplated is a trust. Trusteed mutual funds are ordinarily established by agreement between the management company and a trust company; if the distribution company is separate from the management company, it enters into another agreement with the same trust company. In the case of investment funds offered for public participation by trust companies, the trust instrument is a declaration of trust to which only the trust company is a signatory and which constitutes the trust company trustee of the trust and gives it the powers of the management company and the distribution company. The trust instrument, be it a trust agreement or a declaration of trust, provides for all relevant details concerning the operations of the trust. It thereby excludes the application of most requirements which would otherwise affect the trust under trustee acts or corresponding legislation for such requirements ordinarily apply only in the absence of specific provision in the trust instrument.

1.58 Because the trust agreement and the declaration of trust are subject to minimal legal restrictions governing their content, the mutual fund organizers have very great flexibility available in the decision as to what the relevant provisions should be. Few of these agreements and declarations give any voting rights to the unitholders. Apart from this, their terms are generally fair to the unitholders, but vary greatly as to detail. The only way to be reasonably sure of the rules applicable to a particular unincorporated fund is

by an analysis of the trust document, which is usually not available to the unitholder. Many of its more important provisions are outlined in the prospectus, but that may not be available either. Finally, the fact that many of these documents are subject to amendment without prior consent of the unitholder may decrease the value of disclosure even where full disclosure is made. In this report we make recommendations designed to clarify the position of mutual funds organized as trusts and to minimize the differences between regulations applicable to them and those applicable to incorporated mutual funds.

(d) Restrictions Imposed as a Result of Income Tax Considerations

1.59 Income tax considerations are perhaps of greater importance in an analysis of a financial institution than would be true with any other type of business operation. Dollars are capable of rapid movement, and persons dealing with financial institutions give great weight to tax considerations in deciding whether to deal or continue to deal. A change in the incidence of tax either on the organization itself or on those who invest in it can have an immediate and marked effect on the success of any financial institution.

1.60 Without doubt, the most important constraint presently imposed on Canadian mutual funds as a result of income tax considerations arises from the distinction in existing law between capital gains and income. Every Canadian mutual fund now in operation desires to have its profits resulting from purchase and sale of securities, as opposed to dividends and similar receipts, treated as capital gains rather than income. The reason for this is as compelling as it is obvious: capital gains are presently not subject to income tax.

1.61 There are no cases which precisely delineate the distinction between capital gains and income in the present context, and no official regulations dealing with the point are available. The accepted distinction is between a profit made on the sale of a security acquired for investment, and one made on the sale of a security acquired for trading purposes only. Yet this distinction is not particularly helpful, for the difference between trading and investment is not precise. For this reason, the investment managers of

Canadian mutual funds endeavour to operate their portfolios in such a way that their policy will be regarded as investing rather than as trading. This is done principally by restricting the extent of portfolio turnover. This factor has influenced the trading policies of Canadian mutual funds.

1.62 The Royal Commission on Taxation* recommended certain basic changes in Canadian income tax law, one effect of which would be to make the distinction between capital gains and income no longer relevant to the taxation of mutual funds. At the time of writing, it is not clear whether this aspect of that report will be implemented but in the preparation of the present report we have avoided any recommendations which are premised on an assumption concerning the continuance or otherwise of the constraint on portfolio turnover imposed under the existing income tax law.

1.63 While the point dealt with above is the most important income tax consideration in mutual fund operations, a number of other constraints also arise under income tax law. The nature of these constraints varies considerably between mutual funds, depending upon the categories in which they fall for income tax purposes. Because these categories and their implications are highly technical, and because recommendations for changes in income tax law do not fall within our purview, a description of these rules is included in an appendix. References to Appendix "C" are made where relevant in this report.

(e) Restrictions Resulting from Ethical Considerations; the Rules of the Canadian Mutual Funds Association

1.64 No amount of governmental control can replace a sense of pride and of ethical conduct on the part of the industry or the persons being regulated. Government can deal with overt conduct capable of legislative categorization; only the individual can determine whether a particular action is one that he "should" take in an ethical sense. Individuals can rarely, however, determine the dictates of ethical standards on difficult questions of business judgment without guidance from sources which represent the judgment of their peers. This means that there is need for defined criteria of proper ethical

* Royal Commission on Taxation, Report, Ottawa: Queen's Printer, 1966.

conduct, even though the criteria may not be completely precise and the sanctions for their violation may not be as effective as those for the violation of legislative requirements. In this section, we discuss the principal sources of ethical standards which influence participants in the Canadian mutual fund industry.

1.65 There are two principal sources of criteria for ethical conduct in the Canadian mutual fund industry; practices in the United States developed under the Investment Company Act of 1940, ("the 1940 Act"), and the Regulations and Code of Ethics of the Canadian Mutual Funds Association ("C.M.F.A."). This division is for purposes of analysis only; the two sources are closely related, and the problems dealt with by them are almost identical.

1.66 The Investment Company Act of 1940 was passed by Congress after the Securities and Exchange Commission had established the existence of flagrant abuses in the investment company industry.* While most of those abuses involved closed-end investment companies, the open-end investment companies (mutual funds) were not spared censure in the report and the entire industry as it then existed in the United States was tarred with the brush of abusive practices. As a result, the 1940 Act contains extensive and detailed rules governing the operations of the organizations subject to it; such rules have been elaborated and expanded upon by the Securities and Exchange Commission in its administration of the legislation. These rules have had a major impact on the Canadian mutual fund industry. Perhaps the most important reason is indicated by the following quotation from the brief submitted to us by the Canadian Mutual Funds Association:

> It should be noted that the present levels of mutual fund sales charges may well have been established without regard for the economics of the industry at its inception. In large part they appear to have been modelled on those prevailing in the U.S., possibly because the original entrants in the Canadian industry were spawned by U.S. organizations.

Apart from the carry-over by United States organizations of their practices into Canada, the 1940 Act has influenced Canadian securities administrators in the

* S.E.C. Report on Investment Trusts and Investment Companies (1938-40).

imposition of discretionary requirements on mutual funds. In addition, the Canadian Mutual Funds Association has followed certain of the precepts of the 1940 Act in the formulation of regulations applicable to its members.

1.67 While the similarities between practices in the United States and Canada are of great importance, their extent should not be overemphasized. The provisions of the 1940 Act are helpful as guides to ethical conduct, but even the most ethical participants in the Canadian industry look principally to the spirit rather than the letter of those provisions. Important examples of provisions in the 1940 Act accepted in spirit by ethical participants in Canadian mutual fund industry include those concerning self-dealing transactions; abusive transfers of management and sales contracts; transactions inconsistent with the investment objectives of the mutual fund; and similar matters. The relevance of and degree of need for more specific provisions on these matters in Canada are considered elsewhere in this report.

1.68 The second principal source of ethical criteria for the Canadian industry is the Code of Ethics and Regulations of the Canadian Mutual Funds Association. The history and position of the C.M.F.A. are considered in Chapter XIX of this report. It is sufficient here to note that it is an industry association which represents the vast majority by dollar value of assets, but not by numbers, of Canadian mutual funds. At December 31, 1967, its members included 36 of the 106 Canadian-organized mutual funds* qualified for sale in Canada, with approximately 86% of the assets of such mutual funds. Its membership includes no mutual funds organized outside Canada. Shares or units of all mutual funds that are members of the C.M.F.A. are sold at basic sales charge rates in excess of 8.0%, which indicates that none makes its primary appeal to the shopping goods segment of the market as defined in paragraph 2.42. The principal distribution technique of most C.M.F.A. members is the direct sales force.

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* At the end of 1968, of 117 Canadian-organized mutual funds, 41 belonged to the C.M.F.A.

1.69 The C.M.F.A. requires as a condition of membership that its member organizations adhere to a code of ethics and regulations in their sales practices. Not surpisingly, some of the provisions contained in the code of ethics and regulations seem designed to avoid certain types of competition within the mutual fund industry rather than to contribute to the protection of the investor. Examples include restrictions on the transfer of salesmen between organizations, and restrictions on the use of performance comparisons. Most of the restrictions are, however, designed for investor protection, and the rules they embody are in large part derived from the 1940 Act, regulations thereunder and the rules of self-regulatory industry associations in the United States.

1.70 The C.M.F.A. code of ethics and regulations includes restrictions on the investment practices of member mutual funds which are substantially similar to the limitations imposed by securities administrators and outlined in paragraphs 1.47 and 1.48 above. It also includes provisions as to the independence of directors based on the corresponding rules embodied in the 1940 Act. At least 40% of the board of directors of a mutual fund which is a member of the C.M.F.A. must be "independent directors who are neither directors, officers, employees or equivalents, of the management company or the underwriter or contractual distributor of the mutual fund."* We comment in paragraphs 6.34 and 6.35 on the extent to which C.M.F.A. members actually abide by this provision. The code of ethics and regulations does not include provisions similar to those in the 1940 Act which specify certain specific responsibilities to be assumed by the independent directors. Nor does it include a definition of "independent director" similar to the relevant definition in the 1940 Act.

1.71 The points outlined above are the major areas included in the C.M.F.A. requirements, but a number of other specific questions are also considered. Most of the rules are desirable and in the best interests of the public investor. While our recommendations in most cases go beyond the C.M.F.A. rules, we believe that those rules have contributed to an improvement in the ethical standards of the Canadian mutual fund industry.

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* Canadian Mutual Funds Association, Regulations, 1(b).

1.72 Most members of the Canadian mutual funds industry attempt, we believe, to adhere to a high ethical standard. The criteria referred to in preceding paragraphs have had a beneficial effect in providing guidance to such persons. There is, however, a segment of the industry with lower ethical standards; the aspect of industry operations where that is the most serious problem is the distribution function. In this report we make a number of suggestions designed to lend precision to ethical standards and further to improve the extent of adherence to those standards.

CHAPTER II

DISTRIBUTION OF MUTUAL FUND SHARES OR UNITS; THE COMPETITIVE POSITION

2.01 The entrepreneurial reward of mutual fund organizers is derived from two principal sources: compensation for management, and profit on distribution of shares or units. Compensation for management is almost invariably determined partially or entirely by the amount of the total net assets of the mutual fund. It can therefore be increased through accretion in value of the portfolio, or through sales of shares or units. We have found that rate of return, which is largely a function of accretion in portfolio value, is of great concern to potential purchasers and a superior rate of return can have a favourable effect on sales. This means that the production of a favourable rate of return and a high rate of sales are closely related, and are the two endeavours that can result in high entrepreneurial rewards. They account for the bulk of the effort involved in mutual fund operation. Most of this report is devoted to them or to matters related to them. In this chapter we summarize some of our more important factual conclusions as to the distribution function; the next chapter considers the investment management function.

2.02 An oft-quoted aphorism of the mutual fund industry is that shares or units of mutual funds "are not bought, they're sold". Like many aphorisms, this represents an over-simplification of a complicated situation but contains a significant element of truth. Traditionally, the market for mutual fund shares or units has been regarded as a market in which potential purchasers must be convinced that the suggested investment is desirable and appropriate for them. We decided at an early stage of our work that it was necessary for us not

only to study the mechanics and procedures involved in the marketing process, but also to examine this assumption and its implications. We felt that information on both points was essential to the formulation of recommendations with respect to the marketing of mutual fund shares or units, and would provide highly relevant background information to other questions being considered. The present chapter describes the factual conclusions we have reached on these matters.

Channels of Distribution

2.03 The mutual fund industry makes use of three principal channels of distribution or sales outlets in the sale to the public of shares or units: brokers, independent sales forces, and direct (or captive) sales forces. Other financial institutions that sell mutual funds rely on their usual distribution techniques, commented on where relevant elsewhere in this report. Not all distribution companies make use of all three techniques. Some mutual funds sponsored by brokerage firms are available only through their sponsoring firms. The distribution companies that aim at a wider market usually place principal emphasis either on a direct sales force or on brokers and independent sales forces. Those that sell through a direct sales force may or may not also sell through brokers and independent sales forces; some sell a large volume of shares or units through the latter channels, while others refuse as a matter of policy to accept orders from brokers or independent sales forces. Those that follow the latter policy do so in the belief that it will contribute to the morale of the salesmen on their direct sales forces.

2.04 Historically, sales through brokers who handle mutual fund shares or units as part of a general securities business form the oldest channel for their distribution in Canada. The first major public Canadian mutual funds, Canadian Investment Fund, Ltd. and Commonwealth International Corporation Limited, each of which commenced operations in 1932, were both originally sold in this way. Brokers continued to be the principal sales outlet at least until the mid-1950's. While statistics set out below make it clear that direct sales forces now far surpass brokers in importance as a channel of distribution, a large volume of mutual fund shares or units continues to be sold through brokers. Many commentators on the mutual fund industry consider sales

through brokers to be "better" than sales by direct sales forces, on the theory that the broker has available a variety of mutual funds among which to select and can assist his client to choose the one best suited for him. We agree that sales made on the basis of a comparison designed to select the mutual fund best suited for the purchaser are highly desirable, and we make recommendations in this report designed to increase the percentage of sales made in this way. We do not agree that all sales through brokers are, in fact, based on such a comparison.

2.05 A number of brokerage firms have established separate mutual fund departments composed of persons exclusively or almost exclusively engaged in the sale of mutual fund shares or units. These salesmen engage in active solicitation of orders, following procedures similar to those used by salesmen on direct sales forces. While they usually are able to provide their customers with a choice among several mutual funds, our observations indicate that great emphasis is frequently placed on a particular mutual fund. This emphasis may result as much from the nature of the compensation currently offered by the distribution company of that mutual fund for sales of its shares or units as from a decision by the seller that it is the best mutual fund available. Certainly the distribution companies that rely on widespread distribution through brokers consider it essential to provide maximum compensation for sales. We do not criticize either the creation by brokerage firms of mutual fund departments, or the emphasis by their salesmen on a particular mutual fund; both are natural developments of the current market. We do feel that sales effected through these mutual fund departments should not be regarded as inherently "better" than other types of sales. The comments made in this paragraph are also applicable to independent sales forces, discussed in the following three paragraphs.

2.06 The second channel of distribution is independent sales forces specializing exclusively in the sale of mutual fund shares or units. Composed in large part of persons who were formerly salesmen on direct sales forces, they are independent organizations which ordinarily sell only mutual funds but in a few cases are also able to provide purchasers with debt securities such as short-term notes and Canada Savings Bonds. Each independent sales force has

arrangements with the distribution companies of a number of mutual funds which enable it to make available a variety of mutual funds to its customers. In many cases salesmen on independent sales forces receive a higher proportion of the sales charge than would be available to them as members of direct sales forces, at least of the larger direct sales forces, since the latter must allocate a significant portion of the sales charge to regional or district managers.

2.07 Independent sales forces are a comparatively recent development in the Canadian mutual fund industry. While their growth has been rapid, they are still small by comparison with other channels of distribution. We collected statistical information from 17 of these organizations although perhaps twice that number operate in Canada; our difficulty in the collection of information from the remaining organizations was largely attributable to their small size and lack of clerical staff. The 17 organizations had a total of 341 full or part-time salesmen at June 30, 1967; it is probable that their average number of salesmen was greater than that of the other independent sales forces. Not one of the organizations from which we collected information existed prior to 1960, and it is still too early to make a prediction as to their prospects in the long term.

2.08 In paragraph 2.05 we comment that the pressure on a distribution company to provide maximum compensation for brokers in order to persuade them to sell shares or units offered by it rather than those offered by another distribution company also applies with respect to independent sales forces. This is one reason why the continued growth of independent sales forces might well have a considerable influence on the Canadian mutual fund industry. Salesmen on direct sales forces are increasingly aware that it is open to them to resign and to join or to form an independent sales force. This means that the direct sales forces must compensate their salesmen sufficiently to prevent them from taking that step. Even apart from this, the direct sales forces would be under pressure to compensate their salesmen as well as possible; the existence of independent sales forces ensures that the pressure is at least as intense as is the corresponding pressure with distribution companies that sell through brokers and independent sales forces.

2.09 The third, and by far the most important, channel of distribution for mutual fund shares or units in Canada is the direct sales forces. The first of these were created in the late 1930's and early 1940's; of the two organizations mentioned in paragraph 2.04, Canadian Investment Fund, Ltd. eschewed this approach but Commonwealth International Corporation Limited adopted it at an early date. Its distribution company and those of some other mutual funds established forces of salesmen who sold shares or units of only one mutual fund, or of two or more mutual funds under common management. Despite their late beginning, the direct sales forces rapidly grew in importance with the greatest spurt in number of salesmen occurring during the 1950's.

2.10 In 1950 Investors Mutual of Canada Ltd. was formed and the salesmen of Investors Syndicate of Canada, Limited, which had been distributing investment contracts since 1940, were enabled to offer potential purchasers their choice between investment contracts and mutual funds. In 1957, United Accumulative Fund Ltd. was formed and the companies responsible for distribution to the public of its shares, United Investment Services Ltd. and United Investment Services (Quebec) Ltd., soon developed the largest direct sales force in the country. Sales through direct sales forces rapidly passed sales through brokers as the most important channel of distribution, and the direct sales forces continue to expand.

2.11 We collected detailed statistics on the Canadian direct sales forces that offered shares or units of a mutual fund or of associated mutual funds qualified for sale in Canada at December 31, 1967, and having aggregate total net assets at that date in excess of $5 million. Our information on the remaining direct sales forces is less detailed. Those in the former category had a total of 2,726 full or part-time salesmen at the end of 1962; the corresponding figure at the end of 1967 was 5,682. The percentage of part-time salesmen was stable throughout this period, at about 15% of the total. At the end of 1967 there were 140 salesmen associated with the direct sales forces which are not included in the above statistics because the mutual fund or mutual funds sold by them had total net assets of $5 million or less.

TABLE II-A

CANADIAN MUTUAL FUND DISTRIBUTION COMPANIES WITH OVER 200 SALESMEN AS AT JUNE 30, 1967

Name of Distribution Company	No. of Full & Part-time Salesmen	Mutual Funds Distributed	Principal Investment Objectives of the Mutual Funds*
1. United Investment Services Ltd.	2,236	United Accumulative Fund Ltd	-growth -maximum capital gain -income
		United American Fund Ltd	-growth -maximum capital gain
2. Investors Syndicate Limited	804	Investors Growth Fund of Canada Ltd	-growth
		Investors International Mutual Fund Ltd.	-growth
		Investors Mutual of Canada Ltd	-stability
3. Federated Investments Ltd.	434	Federated Financial Fund Ltd	-growth with stability
		Federated Growth Fund Ltd	-growth
4. I.O.S. of Canada Ltd.	410	Regent Fund Ltd	-growth -maximum capital gain
5. A.G.F. Management Limited	399	American Growth Fund Limited	-growth -maximum capital gain
		Canadian Trusteed Income Fund	-income -security -stability
		European Growth Fund Limited	-growth -maximum capital gain
		Growth Equity Fund Limited	-maximum capital gain -growth
6. All-Canadian Group Distributors Limited	306	All-Canadian Compound Fund	-growth
		All-Canadian Dividend Fund	-maximum capital gain
		All-Canadian Venture Fund Ltd	-maximum capital gain -growth
7. Canadian Channing Corporation Ltd.	239	Commonwealth International Corporation Limited	-balanced fund
		Commonwealth International Leverage Fund Ltd	-growth

* The information in the last column was supplied by the organizations themselves.

2.12 All except one of the direct sales forces listed in Table II-A distributed more than one mutual fund, and the one exception has since the date at which the table was prepared become associated with another mutual fund. This development of mutual funds under common management is in large part a result of the use of direct sales forces. It has been found desirable for the salesman to have available a choice of mutual funds with different investment objectives; this is colloquially referred to as a "stable" of mutual funds.

2.13 One other aspect of direct sales forces should be mentioned: they are expensive to establish, and are only feasible for organizations prepared to make a substantial investment. This may be one reason why the two largest direct sales forces in Canada, the United and the Investors organizations, were both originally established by large organizations from the United States. Probably because of the expense involved, the direct sales force aspect of the industry is dominated by a comparatively small number of organizations. That is made clear by Table II-B.

TABLE II-B
CONCENTRATION OF DIRECT SALES FORCE
SALESMEN BY REGION AT JUNE 30, 1967

Region	No. of salesmen active	% of salesmen in each geographical area associated with the indicated number of the largest distribution companies				
		Largest	2 larg.	3 larg.	4 larg.	5 larg.
Atlantic Provinces	357	21.6	36.4	47.6	58.5	67.8
Quebec	1,536	51.0	64.7	71.9	79.0	85.1
Ontario	1,528	46.3	63.8	73.6	81.2	87.3
Manitoba	224	56.3	74.6	86.2	93.8	98.7
Saskatchewan	399	25.3	44.9	60.7	75.4	82.5
Alberta	660	34.4	55.0	67.7	75.8	83.5
British Columbia	897	47.9	62.3	75.9	82.1	87.4
	5,601					
Canada	5,718	39.1	53.2	60.8	67.9	74.9

Note: This table indicates the percentage of the direct sales force salesmen in each of the geographical regions ~~who~~ were associated with the largest, and the two, three, four and five largest distribution companies. One distribution company, with the seventh largest direct sales force in Canada, could not provide us with a breakdown of its Western Canada salesmen among the four Western provinces. It is therefore not reflected in the percentages for Manitoba, Saskatchewan, Alberta and British Columbia; its total number of salesmen in the four provinces at June 30, 1967 was 117.

2.14 While the differences among the three channels of distribution are important, one similarity is even more important. Regardless of the channel of distribution used, the distribution company retains little of the sales charge levied. As a result of the factors referred to in paragraphs 2.05 and 2.08, distribution companies find it necessary to pay most of the sales charges to the broker, independent sales force, or direct sales force responsible for the sale. The levels of sales charges prevailing among the more widely distributed mutual funds are discussed in the next section; 75% or more is usually paid by the distribution company to those responsible for the sale.

2.15 An approximate indication of the relative importance of the three channels of distribution described above is provided by the fact that in 1967 78% of total sales of mutual fund shares or units (not including investment funds of trust companies) were made through direct sales forces, 17% through brokers, and the balance of 5% through independent sales forces and other channels. These statistics are adjusted to exclude the sales referred to in paragraph 13.81 ; if those transactions were included, the corresponding figures would be 66% through direct sales forces, 30% through brokers, and 4% through independent sales forces.

Terms of Sale of Mutual Fund Shares or Units; the Contractual Plan

2.16 While shares or units of mutual funds are legally securities, as are shares of public companies, they are in practice sold in very different ways. This is in part a consequence of the fact that mutual funds are ordinarily engaged in continuous distribution of their securities and are always required to redeem their outstanding securities on demand by the holders. The differences are, however, more fundamental than this. The distribution companies treat mutual fund shares or units as a product, to be packaged in the manner most likely to produce a sustained high volume of sales. Great flexibility is available to the distribution company in its packaging arrangements, for there is ordinarily no meaningful limit on the extent to which it can call on the mutual fund to issue shares or units or to accept them for redemption at net asset value. We discuss the computation of net asset value in Chapter XIII; for present purposes, it is sufficient to assume that the net asset value of a share

or unit is the worth of the proportionate part of the mutual fund portfolio that it represents. The distribution company may, then, sell shares or units on any basis it sees fit, provided that the price is not less than net asset value.

2.17 The following discussion does not relate to all mutual funds, or to all distribution companies. It applies only to those which levy (subject to the volume discounts described below) sales charges at the prevailing maximum rate of between 8% and 9% of the amount paid by the purchaser. Table II-C clearly indicates that the vast majority - some 61.9% of mutual funds by number and 91.8% by dollar value - of mutual funds sold in Canada are subject to sales charges at this rate, with the bulk clustered at 8.5%, or almost exactly 9.3% of the amount invested in the mutual fund. The competitive factors relevant to this rate and the position of distribution companies that levy lower rates are discussed in the next section, but it is worthy of note here that securities administrators have exercised their discretionary authority to prevent the development of a higher rate.

TABLE II-C
SALES CHARGES LEVIED ON SALES OF SHARES OR UNITS
OF MUTUAL FUNDS QUALIFIED FOR SALE IN CANADA AT DECEMBER 31, 1967

Sales Charge Levied on Minimum Size Purchases as a % of Amount Paid by Purchaser	Number of Mutual Funds	Percentage of Aggregate Total Net Assets of all funds (1)
No sales charge	23	6.1%
0.1 to 2%	3	.3%
Over 2, to 4%	12	1.4%
Over 4, less than 8%	7	.4%
Over 8, less than 8.5%	17	36.0%
Exactly 8.5%	34	38.9%
Over 8.5, less than 9%	13	15.3%
Exactly 9%	9	1.6%
Total	118	100 %

(1) Twelve United States organized mutual funds sold in Canada are reflected on the basis of the portion of their total net assets represented by shares or units held by Canadians.

2.18 The sales charge structure is the fundamental part of the distribution scheme adopted by distribution companies that levy the prevailing rate of sales charges. Each "package" for the sale of shares or units really involves an adjustment in that structure, either in the level of charges on a par-

ticular type of transaction or in the manner in which the charges are collected. Every distribution company, without exception, which ordinarily levies a sales charge of 8.0% or more also provides reduced rates for large volume purchases. The exact arrangements differ considerably between organizations, but that used in the distribution of mutual funds managed by United Funds Management Ltd. is typical. The 8.5% rate is levied on sales of less than \$5,000. Above \$5,000, the sales charge structure is:

on a sale of \$ 5,000 to \$ 14,999	the rate is 8%
on a sale of \$ 15,000 to \$ 24,999	the rate is 7%
on a sale of \$ 25,000 to \$ 49,999	the rate is 6%
on a sale of \$ 50,000 to \$ 74,999	the rate is 5%
on a sale of \$ 75,000 to \$ 99,999	the rate is 4%
on a sale of \$100,000 to \$149,999	the rate is 3½%
on a sale of \$150,000 to \$199,999	the rate is 2½%
on a sale of \$200,000 to \$499,999	the rate is 2%
on a sale of \$500,000 or more	the rate is 1%

The sales charge structure for shares of the most recently organized mutual fund managed by United Funds Management Ltd., United Venture Fund Ltd, differs from that quoted above for smaller sales. The basic rate is 9% of the amount paid by the purchaser, which is reduced to 8¾% on sales of \$5,000 to \$14,999 and to 8½% on sales of \$15,000 to \$24,999. For larger sales, the rates are as quoted above.

2.19 It is of interest that the sales charges levied by the United organization under the rate structure quoted above on sales in excess of \$150,000 are at a lower rate than those previously levied. The reduction presumably constituted a response to competitive pressures. In 1962, the rate on sales in excess of \$500,000 was 3%. At least one other major distribution organization has reduced its rates on large sales, and has also introduced a new mutual fund for which it charges a 9% rate on small sales. Each of these companies, and many other distribution companies (fourteen of twenty-two which advised us of their policies in this connection) are prepared on large sales, in excess of about \$500,000, to negotiate an even lower sales charge than that which would be levied under the normally applicable schedule. It is noteworthy that while the basic 8.5% rate is substantially higher than corresponding stock

exchange commission rates, even under the quoted schedule the sales charge on a large purchase may be less than the commission rates payable on an investment of corresponding size in stock exchange-listed securities. This difference is accentuated when an even lower rate is negotiated for the mutual fund purchase. This fact opens certain possibilities for abuse through short-term transactions which are considered in paragraphs 13.80 to 13.88. The significance of these sales charge arrangements from a competitive standpoint is commented on in this chapter.

2.20 The appeal of reduced sales charges is not limited to large volume purchasers on a lump sum basis. Many distribution companies compute the sales charge applicable to each purchase by reference not only to the amount of that purchase but to other holdings of the purchaser in mutual funds distributed by the same company. In this way the benefits of reduced sales charges are made available even to purchasers who do not purchase as a single investment but make a number of smaller purchases over a period of time. In even more cases the purchaser is permitted to sign a letter of intent in which he indicates his intention to invest a specified dollar amount in the mutual fund within a fixed period, usually twelve or thirteen months. In these cases, the advantage of the lower sales charge on the total amount is extended to the purchaser either by the application of the lower rate to all sales during the period or by the use of the usual rate on the initial purchases and an appropriate adjustment when the total purchases reach the amount required for the lower rate.

2.21 There are a few other instances in which the usual rate of sales charges is lowered or no sales charges are levied. Almost all distribution companies of mutual funds that pay dividends waive any sales charge on reinvestment of those dividends, although some apply a service charge. Partly as a result of the lack of a sales charge, the rate of dividend reinvestment is usually very high; with at least one major mutual fund over 99% of every dividend distribution is reinvested automatically for additional shares.

2.22 As noted in paragraph 2.12, a distribution company that relies on a direct sales force is almost invariably associated with two or more mutual funds with different investment objectives so that salesmen may provide the purchaser with a selection. Most such distribution companies extend to purchasers the right to transfer between mutual funds without payment of sales charges. This right is comparatively little used in practice, but we understand that its availability is regarded as a valuable point to refer to in a sales presentation; in other words, it adds to the attractiveness of the "package". In most cases there is a restriction on the right of free transfer, such as that it may not be used more frequently than once in each year, but these restrictions are often not enforced. In some cases a service charge is applied on these transfers.

2.23 The description above includes all the cases in which most distribution companies are prepared to permit a reduction from the basic sales charge rate. Technically, there are no instances in which distribution companies ordinarily levy a sales charge higher than their basic rate. There is, however, one very important case in which purchasers in practice pay more, and often considerably more. This is the contractual plan, a very important package for sales particularly through direct sales forces. Under these plans, the purchaser indicates his intention (no legally binding commitment is assumed) to make fixed regular payments at specified intervals, usually monthly, over a specified period of time. Details of contractual plans vary considerably between organizations; only an outline of their most important elements is necessary here. All are designed to enable the distribution company to receive a disproportionate part of the purchaser's sales charges early in the life of the plan. It is true of mutual fund shares or units as of other items sold on an instalment basis that the salesman who sells them in this way is anxious to obtain his compensation as quickly as possible rather than wait for the completion of instalments. The contractual plan facilitates this, although it is important to note that the purchaser under a contractual plan receives his shares or units only as they are paid for; the plan differs in this respect from the instalment purchase of a car or similar commodity.

2.24 If the purchaser completes the investment programme contemplated by the contractual plan, the total sales charge levied is at approximately the same rate as the basic rate of about 8.5%, although administration fees usually increase deductions to between 11% and 12% of the amount paid. In a few cases the sales charges are lower where the total purchase is higher or the separate instalments are higher, although there is little consistency between organizations with respect to details of this type. Each distribution company appears to have designed the terms of its contractual plans to provide a saleable package with maximum compensation to the salesman.

2.25 The critical feature of contractual plans is not the rate of sales charges but their manner of payment. To provide the salesman with his compensation as early as possible, a disproportionate part of the total sales charge is paid either at the outset or during an initial period, usually the first year. Here, again, the exact mechanics differ considerably between organizations, although constraints are imposed by the securities administrators. The most important constraints deal with the proportion of payments during an initial period, usually the first thirteen instalments, that may be deducted as sales charges. There are two principal patterns followed in the detailed arrangements. Under the first, referred to by us as prepaid sales charges, an initial payment is made equal in amount to two or more of the instalments which the purchaser has undertaken to pay. No part of the initial payment is invested in the mutual fund at the outset; instead, a portion of it is added to each succeeding instalment until the initial payment is exhausted, which usually does not happen until the final instalment. Should the purchaser cease to pay instalments at any time before the initial payment has been fully absorbed, he loses the remaining balance of the initial payment, and is left with the shares or units purchased by that portion of his payments which remained after deduction of sales charges and service fees. The prepaid sales charge procedure is used by only a few distribution companies, but it is also used by Capital Accumulation Plan Limited and Comptoir Economique de Fonds Mutuel Ltée, two organizations formed to service and administer contractual plans on behalf of brokers. These two organizations are discussed in greater detail in paragraphs 7.50 to 7.53.

2.26 Far more prevalent than the prepaid sales charge arrangement is the type of contractual plan usually referred to as the front-end load plan. Under such plans sales charges are deducted at a high rate, usually between 40% and 50%, from payments during an initial period, usually between twelve and fifteen instalments; in a few cases a longer initial period is used and the percentage deducted is smaller. Deductions from subsequent payments are in amounts such that at the end of the plan the correct total amount has been deducted. This means that the rate of deduction from payments after the initial period is lower than the basic sales charge rate.

2.27 A variant of the contractual plan, which we do not regard as a true contractual plan, was made available until 1967 by Investors Syndicate Limited. Sales charges were deducted from instalments at the basic rate, but the investor was required to pay a cancellation or redemption fee if he failed to complete the plan. The company has advised us that it abandoned this plan, which was more favourable to the purchaser, in favour of a front-end load plan because it could not otherwise compensate its salesmen on a competitive basis. In spite of the fact that the plan formerly sold was not a contractual plan as we define the term, it was sold in the same way and served the same purpose for investors. Such plans are therefore, except where the contrary is specifically indicated, included in the statistics concerning contractual plans provided in this chapter.

2.28 Contractual plans are of considerable importance to the Canadian mutual fund industry. Data compiled by us indicate that the number of plans sold in 1966 was just under 56,000 and that approximately the same number were sold in 1967. They are of particular importance for some distribution companies; they form over 50% of outstanding accounts for at least two distribution companies, and over 40% for an additional five companies. In none of these cases did the net asset value of the shares or units held in contractual plan accounts constitute over 30% of the net asset value at December 31, 1967 of outstanding shares or units of the mutual funds distributed by the distribution companies concerned.

2.29 The principal appeal of contractual plans is to purchasers who are able to put aside comparatively small amounts of money by regular instalments, usually monthly. Of the 207,898 contractual plans outstanding at June 30, 1967, only 48 plans called for instalments of less than $10. However, approximately 47% called for instalments of $10 to $24.99; 31% for instalments of $25 to $49.99; and 22% for instalment payments of $50 or more. 53% of outstanding plans were for ten year terms; the next two terms in popularity were fifteen and twenty year plans, with 33% and 14% respectively of those outstanding.

2.30 Both types of contractual plan, the prepaid sales charge and the front-end load, weigh heavily on the purchaser who fails to fulfil his programme, although their exact impact is dependent on the terms of the particular plan and the stage at which instalments cease. The purchaser under a front-end load plan will lose a substantial portion of his payments if he terminates during the initial period, while the proportionate loss suffered by a purchaser under a prepaid sales charge plan will usually be greater for very early termination and less for later termination; in each case these statements assume the non-applicability of the rescission rights described in Chapter XIV. Under either type of plan (except a prepaid sales charge plan where the initial payment is fully credited back prior to the last instalment, but these are uncommon) the purchaser must complete all instalments if he is to minimize the percentage of his payments deducted as sales charges. Even when the purchaser does complete his programme the results of the investment will almost certainly, except sometimes in a declining market, not be as favourable as would be true if sales charges had been deducted at the same rate from all payments. This is because the excess amount deducted in the first year would otherwise have been invested, and hopefully earning a return, for a longer period.

2.31 In view of the fact that a contractual plan will rarely (except sometimes in a declining market) produce a rate of return equivalent to that which would have resulted if the same instalments had been invested at the same times, as separate purchases subject only to the basic sales charge rates, it is relevant to inquire why they are bought at all. One answer is that the

person who is only able to set aside a few dollars a month could not purchase on a lump sum or separate purchase basis because most distribution companies refuse to accept lump sum purchases below a specified minimum amount, usually between $100 and $500. Some distribution companies make special arrangements for periodic payment plans under which each payment is invested on a lump sum basis; these are often called voluntary plans. The minimum size of monthly payments ordinarily accepted on voluntary plans is, however, more than many investors can afford. In spite of these restrictions, the well informed person able to afford only a small monthly payment could avoid the adverse consequences of the sales charge structure on contractual plans by accumulating his monthly payments until he had enough money to effect a lump sum purchase of the minimum size. So far as we have been able to ascertain, this practice is comparatively rare.

2.32 A second explanation of why contractual plans are purchased is that they provide an element of forced savings, since the investor who has made his first few payments is aware that he will lose money if he does not continue to make payments. We explain our doubts concerning this argument in paragraphs 10.97 to 10.101. In our opinion, the most important reason for the continued success of the mutual fund industry in the sale of contractual plans lies in the simple fact that salesmen are induced to emphasize them by the favourable commission structure, and that the persons to whom they are sold do not make adequate analysis of alternatives. This conclusion derives support from a number of the statistics set out in the following section.

Competition in the Sale of Mutual Fund Shares or Units: The Nature of the Market

2.33 We believe that competition should be relied on to the maximum feasible extent to regulate the operations of a free economy. We also believe that governmental intervention should be avoided where competition can effectively accomplish the same objective. In view of these tenets, we would regard effective competition as the best determinant of appropriate price levels, reflecting as it does both the supply of and the demand for a particular product and the relative merits of competitive suppliers of that product. We have, however, concluded on the basis of our studies that sales charge levels in the

Canadian mutual fund industry are not determined by the operation of competition in the manner contemplated by accepted economic doctrine. We reach this conclusion in spite of the ease of entry into the mutual fund industry and of the large number of mutual funds operating in Canada, two factors that would ordinarily lead to the development of price competition.

2.34 In the next chapter we discuss the features that distinguish mutual funds, and conclude that the three principal determinants of their relative merits from the viewpoint of the investor are sales charges, management fees and quality of investment management. Ideally, all three should be taken into account by the prospective investor, and we discuss in the next chapter how they should be weighed in his analysis. On one of these three factors, quality of investment management, strong competition exists within the industry; this also is elaborated on in the next chapter. The conclusion in the preceding paragraph as to lack of competition at the consumer level relates only to sales charges, although for reasons indicated in Chapter X we there conclude that it is also applicable with respect to management fees.

2.35 A number of the conclusions reached in the preceding section are of direct relevance here. Table II-C indicates the prevalence of between 8.0% and 9.0% of the amount paid by the purchaser as the basic sales charge rate. The fact that mutual funds the shares or units of which are sold subject to that basic sales charge represent only 61.9% by number but 91.8% by dollar value of the Canadian industry indicates that those with lower sales charges (there are none with higher) are, on average, smaller. This tends to confirm the validity of the general assumption of distribution companies that sales charges must be kept as high as possible in order to provide maximum compensation to brokers and salesmen, an assumption which derives stronger confirmation from other evidence, set out below. The business reasons for this assumption are described in paragraph 2.05 with respect to brokers and independent sales forces and in paragraph 2.08 with respect to direct sales forces, but they are essentially the same.

2.36 The obvious question which arises from the position described in the preceding paragraph is why sales charges are not higher than the prevailing rates. The explanation for this lies in the exercise by securities administrators of their discretionary authority. The rules imposed are described in paragraph 10.14; for present purposes it is sufficient to say that the prevailing basic rate is also the maximum rate. This means that as a result of competition to compensate brokers and salesmen the prevailing rate in the industry equals the maximum rate permitted by regulation. This explanation does not, however, alone resolve all the questions that may be asked. The most important unanswered question is how to account for the comparatively small size of the mutual funds sold at lower sales charges, or without sales charges. Other questions can also be asked. Why are the discounts on volume purchases found necessary? Why is it not possible to negotiate lower sales charges on small purchases as it is for large purchases? These questions must be resolved if the competitive position is to be satisfactorily explained.

2.37 It will be noted that the questions raised in the preceding paragraph relate to two different types of competition: that between distribution companies, and that between sales outlets (brokers, independent sales forces and direct sales forces) of a single mutual fund. Competition in sales charges at the consumer level between distribution companies would take the form of reductions in sales charges to reduce the cost of the product to the investor. Competition between sales outlets of a particular mutual fund would be manifested in reductions of sales charges by one sales outlet in order to attract purchasers of that mutual fund from another sales outlet. In the absence of co-operation from the distribution company, the latter type of competition could affect only the broker's or salesman's portion of the sales charges.

2.38 Each of the two types of competition described in the preceding paragraph is desirable and necessary if competition is to be genuinely effective in the establishment of sales charge levels, and two preconditions must be present before they can operate effectively. The first precondition, without which neither type of competition will develop, is the existence of ability and willingness among mutual fund investors to compare sales charges

before making purchase decisions. In the absence of such ability and willingness, distribution companies will not be motivated to reduce sales charges and brokers and salesmen will not be motivated to reduce their portion of sales charges.

2.39 The second precondition relates only to the second type of competition, that between sales outlets of a particular mutual fund. Even if the first precondition is present and they are motivated by consumer pressure to reduce sales charges, they will not do so if they cannot. They must have the ability to reduce their portion of sales charge for the benefit of the purchaser if this type of competition is to develop. We have concluded that the first precondition is unsatisfied in a large portion of the market for mutual funds, and that as a result of policies followed by distribution companies the second precondition is also unsatisfied.

2.40 The conclusions summarized above have had considerable influence in the formulation of recommendations made in this report, particularly the important recommendations in Chapter X concerning sales charges and management fees. For that reason we elaborate on these conclusions in some detail in the following subsections. The first subsection considers the nature of the market for mutual fund shares or units and the ability and willingness of purchasers to compare, particularly with respect to price. The second considers the extent of price competition between sales outlets of the same mutual fund, and the restrictions imposed by distribution companies on such competition.

(a) Nature of the Market for Mutual Fund Shares or Units; Sales Charge Competition Between Distribution Companies

2.41 Our principal finding with respect to the nature of the Canadian market for mutual fund shares or units is that it is composed of two classes of investors, with such major differences between them that it is not misleading to consider them as separate markets. The first class consists of persons with reference to whom the saying that shares or units of mutual funds are "not bought, they're sold" was coined. These are persons who would rarely seek out vendors of shares or units in order to invest in a mutual fund; even though such an investment may be appropriate for them, they will not purchase

until approached by a salesman. They will often purchase from the salesman who approaches them without first obtaining complete information as to the available alternatives, although many purchasers of this type are sufficiently knowledgeable to inquire of the salesman as to quality of investment performance. Investors in this class are frequently referred to in this report as those for whom mutual fund shares or units are "unsought goods".

2.42 The second class of purchasers consists of those who may be convinced by a salesman that mutual funds are appropriate for them, or may make the decision on their own, but who are prepared in either case to seek out the mutual fund most suitable to them. This they do by obtaining comparative information on quality of investment performance, sales charges, management fees and any other factors they regard as relevant. Whether they rely on published analyses for this purpose or conduct their own analysis, they contribute to the type of informed market that is the first precondition of effective competition. Investors in this class are frequently referred to in this report as those for whom mutual fund shares or units are "shopping goods".*

2.43 To cast light on the questions here being considered, among others, we arranged for an extensive series of personal interviews with present and past holders of mutual fund shares or units purchased in lump sum purchases and under contractual plans. All persons interviewed held shares or units which were sold subject to a basic sales charge rate in excess of 8.0%. Statistics compiled in this consumer survey are illustrative of the distinction suggested in the preceding paragraph, although the validity of that distinction can in our opinion be amply confirmed on the basis of observation of the industry. Table II-D based on responses to the consumer survey indicates that in a large majority of cases the salesman took the initiative in arranging the interview, and that in approximately half of all cases the sale was made in a single visit. Of those who replied that the initial contact was made on the

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* The analysis in the text of the "unsought goods" and "shopping goods" concepts and their application to the Canadian mutual fund industry is in large part based on a report prepared for us by Professors Paul Dell'Aniello and Pierre Lefrançois, Study of the Impact of the Marketing Policies of Mutual Fund Companies on the Canadian Investor, a report to the Canadian Committee on Mutual Funds and Investment Contracts, (Montreal, 1969). For a fuller discussion of these concepts, they refer to E.J. McCarthy, Basic Marketing - A Management Approach (3rd Ed. 1968) Ch.12.

initiative of the salesman, 89% of contractual planholders and 85% of lump sum purchasers contacted no other organization prior to the purchase. On the basis of observation we know that salesmen frequently comment on comparative quality of investment performance but rarely on comparative sales charges or management fees. It is appropriate, then, to accept these statistics as confirmation that the bulk of persons who purchase mutual fund shares or units make no comparison on sales charges or management fees prior to the purchase.

TABLE II-D

SOURCE OF INITIATIVE FOR CONTACT WHICH LED TO SALES; NUMBER OF VISITS MADE TO PURCHASER BY SALESMAN

(FIGURES IN PERCENTAGES)

	Contractual Planholders		Lump Sum Investors	
A) Source of initiative for contact which led to sale				
% of respondents taking the initiative....		24.7		36.8
% who said salesman took the initiative...		73.7		62.2
% Do not remember, or no answer..........		1.5		1.1
B) Number of visits				
0 (decision reached without a visit)......		13.1		20.5
1 visit..................................		53.5		44.9
2 visits.................................	15.4		14.0	
3 visits.................................	9.7		8.1	
4 visits.................................	4.6		3.8	
More than 4 visits.......................	2.6		3.8	
Unspecified, but more than 1 visit.........	1.0		4.9	
Total for more than 1 visit		33.3		34.6

Note: The information in these tables is based on responses made by persons interviewed in the course of the consumer survey conducted under the auspices of this Committee.

2.44 Other replies made in the consumer survey provide further confirmation for the conclusion we have reached about the bulk of purchasers. These indicate not only that purchasers do not compare sales charges and management fees before making a purchase, but that most of them are not aware that differences exist on these points concerning which comparisons might be relevant. Respondents were asked about differences between mutual funds. Only 43% of the contractual planholders and 51% of the lump sum purchasers thought there were any significant differences between mutual funds. Of those who thought such

differences did exist, 10% of the former category mentioned sales charges and the same percentage mentioned management fees, while 11% of lump sum purchasers mentioned sales charges and 13% management fees. By comparison, 46% of those respondents in each category of purchasers who thought that significant differences existed, alluded to performance.

2.45 In connection with the above statistics, it is noteworthy that the brief of The Canadian Mutual Funds Association includes a discussion of competition which concludes that "a statistically significant relationship exists between a fund's past performance and its level of sales", and accepts this as "evidence that mutual fund investors, as a group, act as if they were a relatively well informed clientele". We regard this conclusion only as support for the existence of competition in the area of quality of investment performance. To the extent that it purports to relate to sales charge competition it is inconsistent with the statement quoted in paragraph 2.51, with which we concur.

2.46 While the preceding discussion clearly indicates that most purchasers do not compare mutual funds on the basis of sales charges, a significant percentage of purchasers do make such comparisons. These are the purchasers to whom mutual funds are shopping goods. It is important to emphasize that their comparative analyses would not necessarily lead to the selection of a mutual fund with sales charges lower than the prevailing rates, for they might reject such mutual funds on the basis of quality of investment performance or size of management fees. In spite of this, we believe that such purchasers account in large part for the growth of trust company investment funds and the few other mutual funds that are sold with sales charges levied at a basic rate of less than 8.0% or without sales charges. These represented about 6.2% of the total net assets of Canadian mutual funds qualified for sale in Canada at the end of 1962, and about 8.2% at the end of 1967. The conclusion that their growth is largely attributable to purchasers who regard mutual funds as shopping goods is supported by a survey we conducted of holders of units issued by one trust company investment fund. 72% of them were not previously clients of the trust company concerned; 84% contacted the trust company on their

own initiative; and 82% of them regarded the absence of a sales charge as either the most important factor or one of several important factors that influenced their investment decision. Nor were sales charges the sole factor which influenced their decisions; 59% said that before deciding they investigated the past performance of the investment fund. These facts add weight to the conclusion that many participants in trust company investment funds had weighed the relative merits of mutual funds, giving due weight to sales charges and to other factors, and had decided that the trust company investment fund was appropriate for them.

2.47 The other major indication of the existence of a shopping goods segment in the mutual funds market is the reduced sales charges on large volume purchases, and particularly the willingness of many distribution companies to negotiate even lower sales charges on very large purchases. The nature of these reductions is outlined in paragraphs 2.18 to 2.20. Since they are granted by the distribution companies and do not ordinarily vary between sales outlets of a particular mutual fund, they must be regarded as manifestations of competition between mutual funds rather than of competition between sales outlets of a single mutual fund. Distribution companies that ordinarily levy a basic sales charge rate in excess of 8.0% are not prepared to rely solely on quality of investment performance or on management fees to persuade large volume purchasers to invest in their mutual funds rather than in mutual funds that are available with a low sales charge or without any sales charge. With respect to sales charges, the large volume investor in Canadian mutual funds operates in a competitive environment; the extent of the competition is well indicated by the reductions made by two large distribution companies between 1962 and 1967, described in paragraph 2.19. It is further confirmed by the willingness of most distribution companies to negotiate with large volume purchasers for even lower sales charges than those applicable under their published rate structures. The small volume investor, on the other hand, obtains the benefit of sales charge competition only to the extent that he is able to

select one of the mutual funds available at sales charges below prevailing rates, or without sales charges. This means that competition at the level of the smaller purchaser operates only between distribution companies, not between sales outlets.

2.48 It might be said that the availability of volume discounts is attributable to economies of scale in handling large orders. While such economies may account for a portion of the difference, it is scarcely credible that they constitute an adequate explanation for the fact that sales charges, on a percentage basis, may be 17 times as great on a small transaction as on a large transaction; the difference between 8.5% and .5% is too great to be susceptible of such ready explanation. In addition, in the situations described in paragraph 2.20 purchasers are allowed to accumulate virtually unlimited numbers of small purchases to take advantage of volume discounts, and economies of scale are unlikely to be present in such situations.

2.49 Our conclusion with respect to the nature of the market for mutual fund shares or units is, then, that the great majority of purchasers are sold mutual fund shares or units as unsought goods. They may ask for information as to quality of investment performance, but they do not compare sales charges or management fees; indeed, they are often unaware that differences exist on the latter points. On the other hand, a significant number of purchasers, particularly large investors, do treat mutual funds as shopping goods and make comparisons on all these points. They have induced the distribution companies with basic sales charge rates of about 8.5% to adjust those rates downward on large purchases. They also account in large part for the growth of mutual funds, including trust company investment funds, that are available at lower sales charges, or without any sales charges.

2.50 Certain of our factual findings on the nature of price competition at the consumer level in the distribution of mutual funds concur with certain of the findings reached by The Canadian Mutual Funds Association, although its brief derives different conclusions from those we have reached. The C.M.F.A. brief includes statistics on the number of mutual funds with shares or units sold at different rates of sales charges. It treats mutual

funds organized prior to January 1, 1962 separately from those organized after that date. The brief proceeds as follows:

> While nearly 40% of the newer funds had a zero acquisition fee, only 16 percent of the older funds had this fee. In large part this pattern reflects the entry of trust companies into the mutual funds industry. They sponsored most of the funds in the latter period having zero acquisition charge. The existence of a large number of funds having zero acquisition fee gives the potential purchaser of a mutual fund a very clear choice in terms of the acquisition charge he need pay. He need only incur as high an acquisition fee as his needs for investment information and counsel dictate. Wide choices of this type are consistent with a well-functioning market system that caters to the needs of all consumers regardless of their background knowledge and economic circumstances.

2.51 There are two footnotes to the above quotation. The first comments that a trust company's ability to sell an investment fund without a sales charge is dependent on the use of over-the-counter facilities that are available for other aspects of business and on sales being to purchasers who "do not require seeking out". The second footnote refers to a discussion in another portion of the brief that reviews similar statistics and concludes as follows:

> This evidence suggests that, at least under present conditions, few Canadian investors have taken the trouble to seek out funds having zero sales charges, or else that they felt the possible saving in sales charges was offset by other factors, such as restricted choice in offerings. We are inclined to favour the first explanation, since there is ample evidence that the majority of Canadians are not sufficiently familiar with (or convinced of the advantages of) equity investment to seek out a fund on their own. Funds are not easy to sell to investors who lack this degree of sophistication.

In our opinion, the factors noted by the C.M.F.A. are the very reasons for the lack of adequate sales charge competition between distribution companies at the consumer level.

(b) Constraints on Sales Charge Competition Between Sales Outlets of a Mutual Fund

2.52 The distribution companies that levy the prevailing basic sales charge rate of approximately 8.5% must accept a substantial competitive disadvantage from the viewpoint of the knowledgeable investor, although one that can be surmounted by superiority with respect to investment performance or

management fees. Rarely can such clear superiority be adequately demonstrated. Given these facts, it would be reasonable to expect informed purchasers even of small dollar amounts to demand that the broker or salesman reduce his portion of the sales charge in order to reduce the price to the purchaser, and it would also be reasonable to expect some brokers and salesmen to acquiesce to such requests in order to make the sale.

2.53 The ability to make arrangements such as suggested above, where the broker or salesman reduces his compensation to persuade the purchaser to buy, is of the essence of competition. If the broker or salesman is in a strong position, either because of heavy demand or because his product is substantially superior to that of his competitors, he will probably not yield to the purchaser's request. In other cases he will agree to the reductions, being forced to do so by competition. It is through this type of occurence that competition is most effective. If the flexibility to make such arrangements is restricted, to that extent the operation of competition is also restricted.

2.54 Distribution companies of mutual funds, like those in equivalent positions in the distribution of almost every product, are anxious to prevent those engaged in sales to the public from voluntary reductions of their compensation. The arguments advanced to support that policy are discussed in Chapter X. We are here concerned with the means used to implement it. The distribution companies follow policies of retail price maintenance, taking steps to prevent the development of voluntary reductions in sales charges. This has been comparatively easy with direct sales forces, for they are in a strong position to prevent their salesmen from cutting their portion of the sales charge. The individual salesman would have comparatively little flexibility in any event because of the portion of total sales charges that is allocated to regional or district managers. Apart from this, while his relationship with the distribution company is ordinarily in law that of an agent, he is in fact subject to guidance and direction from it. These factors effectively combine to prevent salesmen on direct sales forces from attracting sales through reductions in sales charges.

2.55 The position with respect to independent sales forces and brokers is different. They are not under the control of the distribution company, and could readily reduce their portion of the sales charge. To prevent such a development, distribution companies enter into agreements, oral or written, with the independent sales forces and brokers under which the latter agree that they will adhere to the sales charge structure prescribed by the distribution company. It is usually understood that the distribution company will refuse to effect further sales through a broker or independent sales force that reduces its sales charge to reduce the purchase price. While we have not conducted a detailed study of this question, the information available to us indicates that these agreements are complied with and that the distribution companies have succesfully maintained the sales charge structure on purchases not of sufficient size to command volume discounts.

2.56 The agreements, oral or written, entered into by the distribution companies with independent sales forces and brokers also deal with another possibility that might result in the availability to the public of mutual fund shares or units at lower sales charge rates. The spread between the selling price and the redemption price of mutual fund shares or units to which an 8.5% sales charge is applicable is sufficient that a secondary market can be operated within the spread. If the sale price is $10 per share or unit and the redemption price $9.15 an enterprising broker or independent sales force could effect redemptions at, say, $9.20 and sales at, say, $9.75 and still have a substantial margin of profit. Under the agreements referred to above the brokers and independent sales forces agree that they will not carry on such a secondary market. The attempt to prohibit this development has not been completely successful, because any broker can start a secondary market whether or not he has an agreement with the distribution company. While the secondary markets that have actually developed are limited in extent and do not pose a substantial threat to the maintenance of the pricing structure, we regard the possibility of further developments in this area as a significant danger, not because it would mean more competition but for other reasons. These are described in paragraphs 10.52 to 10.54.

2.57 By controls over direct sales forces and agreements with independent sales forces and brokers, the distribution companies have successfully prevented the development of any significant price competition between those engaged in the sale to the public of a single mutual fund. When combined with our conclusion that the level of price competition between mutual funds is not satisfactory, this leads to the conclusion that competition cannot be relied upon as an adequate regulator in this aspect of industry operations. We make a number of recommendations in this report designed to improve the level of competition, and in Chapter X we make specific recommendations to deal with management fees and sales charges until a satisfactory level of competition develops.

CHAPTER III

INVESTMENT MANAGEMENT AND BROKER RELATIONSHIPS

3.01 Great stress is placed throughout this report on the desirability of competition within the Canadian mutual fund industry. If competition functions effectively, it provides incomparably the best control over industry operations within a free market both from an economic and a regulatory standpoint. Ideally, each purchaser of mutual fund shares or units would compare the available mutual funds to determine, on the basis of all available and relevant information, which was most appropriate for him. The ideal is obviously impossible of complete attainment. The costs involved in communication of all the relevant information in sufficient detail and in comprehensible form to all potential investors would be prohibitive. While competition can operate even if not all investors make comparisons, and even if few make complete comparisons, its effectiveness will improve with an increase in the number of investors who compare and with the quality of the information they use. In Chapter X and elsewhere in this report we recommend procedures to increase the willingness of investors to compare and to increase the availability of information for comparisons; in other words, we seek to expand the segment of the market for mutual fund shares or units which treats them as shopping goods. This chapter is largely devoted to a discussion of the factors that are relevant to the investor who proposes to make a careful comparison among mutual funds.

3.02 In the selection of a mutual fund the three most important items for comparison are sales charges, management fees and quality of investment management. It is apparent that the last of these three is of greatest importance to almost any investor, although a slight superiority in quality of investment management may not compensate for higher sales charges or management fees; the weighing of quality against price is one of the things a competitive market does best. The only investors to whom quality of investment management might be of comparatively small importance are those investing on a short term basis and those with special and unusual needs, such as for a mutual fund that invests exclusively in securities issued by companies in one region of the country.

3.03 In spite of its importance, quality of investment management is difficult to measure and may be impossible to predict. To measure it involves a determination of what constitutes good investment management, a difficult problem in itself. To predict it involves acceptance of standards of good investment management and the use of available information to determine whether and to what extent they will be adhered to in the future. Such a determination may be impossible with a mutual fund, dependent as it is on the vagaries of the market-place and the skill of its investment managers. These problems of measurement and prediction are considered in the following discussion. For convenience, the word "performance" is used to refer to the quality of investment management.

3.04 In the next section we discuss the criteria relevant to measurements of performance, with particular reference to rate of return. We then describe one possible approach to a comparative assessment of performance as applied by consultants to this Committee. The remainder of the chapter reviews some of the principal characteristics of investment practices of Canadian mutual funds, including the use of reciprocal business.

Factors Relevant to Performance:
The Emphasis on Rate of Return

3.05 All investors are interested in making profits, and it is therefore apparent that relative profits are of great significance in comparisons of performance between mutual funds. For this purpose, it is unnecessary to distinguish between realized and unrealized profits, and profit can appropriately be expressed as an annual percentage rate of return. For any year, the rate of return on shares or units of a particular mutual fund can be calculated by adding the net asset value at the end of the year to the total of all distributions made, per share or unit, during the year subtracting the net asset value at the beginning of the year, and dividing the result by the net asset value at the beginning of the year. The result is usually expressed as a percentage. Rate of return is, however, not the only relevant determinant of performance. We believe that competition between mututal funds has tended to accord more emphasis to comparisons of rate of return than is warranted even by the undoubted importance of that information.

3.06 Performance is a subjective concept, since to an investor the best performing mutual fund is the one which most nearly satisfies his personal investment objectives. The importance of rate of return to assessments of performance made by or for any investor is obvious. But for many investors a competing consideration is present: the desire to limit the degree of risk accepted in the pursuit of a high rate of return. It is obvious that the aged widow with modest resources, much as she would like to make money, should not ordinarily invest all her savings in an aggressive mutual fund that pursues a high-risk investment policy in an endeavour to attain maximum rate of return. On the other hand, the young businessman with good prospects should not put his current surplus income into a conservative mutual fund which stresses safety of capital. These two examples, (each of which should be qualified by the possibility of the type of portfolio adjustment discussed in paragraphs 3.12 and 3.13) are only representative of the variety of levels of risk tolerable to different investors. Many mutual funds appeal specifically to investors on the basis of the

level of risk they are prepared to accept. To compare the conservative mutual fund with the risk-oriented mutual fund solely on the basis of relative rates of return is obviously wrong.

3.07 Since early in 1967 a number of mutual funds with investment objectives that contemplate the acceptance of risk in order to increase the rate of return (often referred to as "venture" funds) have had very considerable success. They have produced frequently good, and sometimes excellent, rates of return; in this they have been assisted by a generally rising stock market, but in some cases their rates of return have been substantially higher than those which would be attained through investment in the securities that form recognized market indices. It is difficult to state with precision what mutual funds should be classified as venture funds, but we are prepared to accept as indicative of the success of these mutual funds statistics contained in the brief of the Canadian Mutual Funds Association and based on a classification prepared by that Association's consultants. The brief states that for the period January 1, 1968 to June 30, 1968, net sales of the five venture funds then included in C.M.F.A. membership totalled $51.8 million, while net sales of all its other mutual funds were only $4.1 million.* These figures clearly indicate the remarkable extent to which venture funds have been accepted by the Canadian public.

3.08 Venture funds have a very important role to play and provide a valuable service to investors for whom they are appropriate. The problem is that their success and the public interest in them have accentuated the public demand for high rates of return. In our opinion, this demand has not been accompanied by full recognition of the degree of risk involved. Financial newspapers regularly publish lists of mutual funds ranked by their rate of return, often over an unrealistically short period; the advice we have received is that adequate analysis cannot be made without at least five years of historical

* We have been advised that corresponding figures for the entire year 1968 were $105.2 and $102.3 million respectively. However, during the second half of 1968, AGF Special Fund Limited was organized and raised $60 million on the basis described in paragraph 5.09. It would be appropriate to treat this as a venture fund, which would change the latter figures to $165.2 and $42.3 million respectively.

information, and that even that amount of information might not be of value for purposes of predictions. Since most of the venture funds have been organized since 1966, this means that even if an accurate measurement of their performance to date is possible, no prediction can be made as to their future performance. Salesmen of the top-ranked mutual funds nonetheless make effective use in sales presentations of the published rankings based on rate of return, often without proper explanation and qualification. One of the principal objectives of the discussion in the next section of this chapter and of the related recommendations made in subsequent chapters is to encourage the development of analytical techniques that adequately reflect both risk and rate of return.

3.09 Those investors who are conscious of the importance of the level of risk accepted often look for indications of policies on this important question to the statements, contained in mutual fund prospectuses and sales literature, of investment objectives and the practices to be used in the attainment of those objectives. These statements are designed to apprise the investor of policies adhered to in the management of his mutual fund. They ordinarily specify the objectives being sought in the investment management of the mutual fund and the practices and techniques open to management to achieve those objectives. One of their principal functions is to indicate the priority accorded a high rate of return in the management of the mutual fund, and the degree of risk that will be accepted in pursuit of that objective.

3.10 The language in mutual funds' statements of investment objectives and practices dealing with the acceptable degree of risk is almost invariably very vague, but usually at least indicates a general philosophy of investment management. The following extracts from the investment objectives of two associated Canadian mutual funds are illustrative of this point. The first reads, "The fund has as its principal objective long-term growth of invested capital". The second reads, "Its [the fund's] principal objectives are to provide a reasonable return on investments made and long-term growth of capital, and to protect the value of the shareholders' investment". While these are couched in similar terminology, and neither is meaningful when considered alone,

the reader who compares them will quickly (and correctly) deduce that the policy followed in the investment management of the second is more conservative than that of the first.

3.11 Statements of investment objectives and practices may be of considerable value to the investor, and we make recommendations in Chapter XII designed to encourage more precision and detail in such statements. We also think that some emphasis should be given to these statements by persons responsible for the dissemination of lists that purport to rank mutual funds by rate of return. Notwithstanding our recommendation in Chapter XII, we doubt that statements of investment objectives can be made sufficiently precise to permit exact ranking of mutual funds by degree of risk. In addition, investment managers may have differences of opinion as to what type of investments are consistent with what level of risk, so that policies actually followed should be taken into account. What is needed is an analytical technique that reflects both risk and rate of return, and that determines risk at least in part by actual experience.

3.12 In the development of an analytical technique to combine risk and rate of return it is of considerable importance that, even when risk levels are determined, the investor is not restricted to mutual funds that accept the degree of risk appropriate for him. The widow who is impressed with a particular mutual fund which is managed on a high-risk basis might invest, say, only one-half of her savings in it and keep the remainder on deposit in a bank. Similarly, the young businessman might be impressed with a conservatively managed mutual fund, and invest in it not only his surplus income but also a portion of the amount that he would ordinarily keep in the bank. Through these techniques, an investor who is able to decide the level of risk acceptable in his portfolio, and is able to estimate the relative degrees of risk in various investments, can adjust his portfolio to arrive at the desired level of risk although some of the included investments involve less or greater risk.

3.13 Acceptance of the approach outlined in the preceding paragraph would make it unnecessary for the investor to exclude mutual funds from consideration because the level of risk followed in their investment management was inappropriate for him. It would, however, leave open the question of what other

factors about a mutual fund might impress him sufficiently to persuade him to adjust his personal portfolio in this way. The only such factors would be any which might lead him to believe that a particular mutual fund would attain in the future a higher rate of return than that attained by other mutual funds at the same level of risk. He could arrive at this conclusion on either or both of two bases: the ability of the persons responsible for investment management, and the historical record of results.

3.14 The relevance of the first of the two bases mentioned in the preceding paragraph is apparent. Investment management must be performed by individuals, whose abilities are crucial to the results produced. This has been recognized by investors in the United States, where some investment managers have acquired such favourable reputations that their association with a mutual fund is of itself sufficient to produce a high volume of sales of its shares. Similar developments may be expected in Canada as the shopping goods segment of the market for mutual funds expands and various investment managers acquire wider reputations. In Appendix "E", we recommend that prospectuses should contain detailed information concerning the background of individuals responsible for investment management, but apart from cases where such individuals are known to the prospective purchaser by reputation we doubt that this information wil be of direct assistance to investors. To judge the ability of individuals is a difficult task at any time; it is virtually impossible if the only basis for judgment is a few facts set out in a prospectus.

3.15 The relevance of the historical records of results attained in making comparisons between mutual funds is more controversial. In paragraph 3.08, we mention the advice we have received that adequate analysis of mutual fund performance cannot be made without at least five years of historical information. This does not necessarily mean that even with five years of information the analysis will be helpful for predictive purposes, and one of the purposes of the study summarized in the following section was to determine the extent to which predictions of future performance could actually be made. Regardless of the conclusions there reached, we recognize that the historical

record will inevitably be used, for want of anything better, as one factor in the comparison of mutual funds. Another purpose of that study was to provide suggestions as to how the element of risk could best be taken into account in historical analyses, in order to avoid the undue emphasis on rate of return that we note above.

3.16 The preceding discussion reaches no firm conclusion concerning methods of comparison between mutual funds, other than that undue emphasis should not be given to rate of return without allowance for the element of risk. We would be content if the only result of the discussion were to be greater emphasis by the Canadian financial press on the relevance of differences in investment objectives when rankings are made of mutual funds. We hope, however, that this and the following section will together suggest new approaches to be followed by regulatory authorities, the press, and the mutual fund industry in the comparative assessment of mutual funds.

Analysis of Canadian Mutual Funds Based on Historical Rate of Return and Risk

3.17 To obtain advice on the problems discussed in the preceding section, and related problems, we consulted Professors Richard Bower and J. Peter Williamson of the Amos Tuck School of Business Administration at Dartmouth University. We asked them to consider the degree of predictability in results attained by Canadian mutual funds, and the relationship, if any, between such results and the presence or absence in mutual fund operations of each of several factors. In co-operation with us, they conducted a study of these questions and prepared a detailed memorandum to report on that study. The contents of that memorandum are both concentrated and technical. For purposes of this report, we limit our discussion to a summary of the general approach taken, comments on the value of that approach, and references to the more important conclusions reached. We also received a helpful memorandum on this topic from the Canadian Mutual Funds Association.

3.18 The analyses conducted by Professors Bower and Williamson were based on principles expounded in two articles that consider the definition of risk and the relationship between risk and rate of return.* We do not propose here to attempt a detailed explanation of these methods; the technicalities involved are such that considerable space would be required, and the articles referred to in the footnote are readily available. It is, however, important to explain in general terms the assumptions upon which the analyses are based. The first and most important assumption relates to the definition of risk. The analyses do not rely on the published investment objectives of mutual funds to determine the degree of risk assumed in their investment management, although the ranking by risk arrived at by the analyses used was similar to that arrived at through a study of the investment objectives of the mutual funds concerned.

3.19 The assumption as to the meaning of risk that was used in the analyses conducted by Professors Bower and Williamson was that risk can be equated with variability or volatility of the mutual fund. As between two mutual funds, the one with the smaller fluctuation in its annual rate of return over a period of years will be regarded as having the lower degree of risk. In one method of analysis the degree of fluctuation is judged by comparison with a relevant market index; in the other, the annual fluctuation is determined by reference to the average annual rate of return of the mutual fund over the years under consideration. This equation of risk to historical variability or volatility is fundamental to the analyses conducted and is one that is not universally accepted. Professors Bower and Williamson do not contend that it is an ideal approach, but do contend that it employs the most current analytical tools for use in the assessment of investment management and that by providing a measurement of risk that can be combined with rate of return it provides a considerable improvement over any technique based entirely on rate of return.

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* W.F. Sharpe, Mutual Fund Performance, (Jan. 1966), XXXIX Journal of Business 119.
J.L. Treynor, How to Rate Management of Investment Funds, (Jan. - Feb. 1965), XLIII Harvard Business Review 63.

3.20 The next step in each of the analyses is to arrive at a relationship between risk and rate of return so that all mutual funds, may be ranked according to the quality of their investment management regardless of the degree of risk assumed in that management. The basic assumption made here is the validity of the method of personal portfolio adjustment described in paragraphs 3.12 and 3.13 under which an individual may attain the level of risk appropriate for him even though he invests in a mutual fund which accepts a different level of risk. This is done by considering his mutual fund investment together with his savings account and adjusting the relative investments in them to attain the correct risk level. The precise techniques used in the two analyses differ but both rely on this method. Use is made of the rate of return that would be produced by a relatively risk-free investment such as a savings account. This rate of return is combined with the rates of return earned by mutual funds and the variability or volatility in such rates to determine what mutual fund achieved the greatest improvement over the risk-free rate of return with the smallest commensurate amount of risk. The techniques used permit all mutual funds studied to be ranked on this basis. Quality of investment management or performance is, then, tested by the combination of risk and rate of return on an historical basis, with risk determined as outlined above.

3.21 It is of interest to note that, at least in theory, a venture fund could be regarded under the methods of analysis described above as a comparatively risk-free investment, if its rate of return over the period considered displayed little variation on the tests of risk outlined in paragraph 3.19. Correspondingly, a conservative mutual fund with a rate of return that fluctuated considerably during the period might be regarded as comparatively risky on this test. In practice, this result is rarely reached but the theory seems to us appropriate. We would regard a venture fund that has produced a high rate of return over a period of years as a safer investment than a comparatively conservative fund that has produced, on average, a low rate of return but with considerable fluctuations.

3.22 The advantages of the type of analysis here being considered are obvious: it facilitates the assessment of mutual fund investment management by comparison with the results of other types of investment, so that credit may be given if losses are minimized while the market as a whole declines and undue credit will not be given for apparently good results obtained when the market is rising. More importantly, it provides a method whereby the investor can assess the comparative merits of mutual funds with different investment objectives, which would be a very desirable development. This is not to say that these methods of analysis necessarily overcome the difficulties that arise in any attempt to predict future results on the basis of the past record; they do facilitate a study of the extent to which such a prediction can be made, and of which aspects of the past record are most likely to be of relevance in the prediction. On the other hand, there are several difficulties in the methods of analysis, even assuming acceptance of the basic premise that risk may appropriately be equated with historical variability or volatility.

3.23 Perhaps the major defect in the analytical technique outlined above is that it cannot be applied to all mutual funds. As noted in the preceding section, Professors Bower and Williamson are of the opinion that quality of investment management cannot be assessed on the basis of less than five years' experience. This excludes from consideration all mutual funds organized less than five years prior to the time of the analysis. Secondly, there are obvious deficiencies in the test as applied to a particular mutual fund if there has been a change in the persons responsible for its investment management during the period under study, or if a major change has occured in its investment objectives. While these are significant defects, it is important to realize that they exist with every currently available technique for the determination of quality of investment management, and it seems highly unlikely that a technique will be evolved which will overcome these problems.

3.24 Because the assumption concerning the meaning of risk may be open to question; because of the difficulties referred to in the preceding paragraph; and because the entire approach requires that any investor who would make use of it possess a degree of sophistication and personal discipline that

cannot always be assumed, we have concluded that the methods of analysis used by Professors Bower and Williamson should not be given official recognition as part of the regulatory structure. For the same reasons, we have not relied on them in the formulation of recommendations in this report, although they served a valuable function in contributing to our understanding of the industry. The analysis should not be overlooked in the regulatory structure; stress should be placed on the approaches discussed in the preceding section, including requirements as to the clarity and manner of presentation of investment objectives and practices to assist the investor in his appraisal of potential risk. In this connection, it is noteworthy that Professors Bower and Williamson tested whether their conclusions as to the ranking of mutual funds on the basis of risk determined by historical variability or volatility accorded with a similar ranking made on the basis of published investment objectives. They found that an analysis of published investment objectives "will enable an intelligent investor to locate a fund reasonably well in this spectrum [meaning the spectrum of risk as determined by variability, from minimum risk to maximum risk], although he will have to read a great many prospectuses before he can have any idea of the relative position of any one fund".

3.25 The tests conducted by Professors Bower and Williamson made use of data concerning 54 Canadian mutual funds the shares or units of which were sold in Canada during the six-year period 1962 to 1967, of which only 24 were sold for the eleven year period 1957 to 1967. The tests are, then, based on a number of mutual funds substantially smaller than that presently in existence, and do not include any of the venture funds referred to in paragraph 3.07. The results are briefly summarized in the following paragraphs. It should be noted that almost all of the results are based on statistical tests of the relationship between two factors, referred to as regression or correlation analyses. Such relationships are a matter of degree, which accounts for the references to "strong indications", "weak indications" and similar terms in the following discussion:

(a) Mutual funds with a high rate of return over one five year period tend to show a high rate of return over the following five year period, but the correlation is very weak. However, there is a strong indication that mutual funds that are found to have a high or low risk level during one five year period will have a corresponding risk level in the following five year period. This would indicate that while historical records of rate of return do not provide a good basis for prediction of future rates of return, historical records of risk may provide a basis for prediction of future risk. This finding should be considered together with the finding, quoted in paragraph 3.24, that it is possible to place most mutual funds on the spectrum of risk through careful analysis of their published investment objectives by comparison with those of other mutual funds.

(b) The tests referred to in (a) dealt separately with risk and rate of return. Tests were made to assess the predictability of the combination to determine whether the "best" mutual fund in one period based on a ranking that combines risk and rate of return is likely to be the "best" mutual fund in the following period. These tests indicated a low level of predictability. This result casts doubt on the value of historical information in the prediction of the relative ranking of mutual funds on the basis of combined risk and rate of return.

(c) A number of tests were conducted in an attempt to assess the influence of various factors on mutual fund performance (used here in the sense of combination of risk, determined by historical variability, and rate of return). Several of these tests were of a preliminary nature and more complete analyses were not done. For that reason, some of the relationships between the factors studied may in fact be stronger than the results indicate; it is doubtful that any are weaker. An attempt to determine relationships based on the size of mutual funds produced no strong

results. Similar tests conducted from the viewpoint of the investor after allowance for sales charges resulted in a weak indication that high performance is associated with large size when sales charges are ignored and with small size when sales charges are considered. This result may indicate that some smaller mutual funds sold without sales charges had performance poorer than the large mutual fund when sales charges were ignored but superior when sales charges were considered.

There was slightly stronger indication that stability in rate of return is associated with larger mutual funds; this finding should be considered together with a finding that there was a weak inverse correlation between the number of securities held and performance, indicating that portfolios with a smaller number of securities tended to out-perform those with a large number.

(d) Attempts to determine whether mutual funds with higher sales charges had superior performance produced no correlations of sufficient strength to justify inclusion here. Similar tests conducted from the viewpoint of the investor after allowance for sales charges indicated the impact of sales charges particularly where holding periods were comparatively short, with the relationship substantially weaker for a five year holding period than for a one year holding period. In other words, mutual funds with shares or units sold subject to a sales charge would appear not to out-perform mutual funds of which this is not true, from the viewpoint of the investor who holds for only one year; from the viewpoint of the investor who holds for five years, the difference between the two is small. Other tests made after allowance for the impact of sales charges consistently confirmed that if a one year holding period was assumed, sales charges had a major effect on results while with a holding period of five years, the impact was substantially weaker.

(e) Tests were made on the basis of the ratio of management expenses paid by the mutual fund, including but not limited to the management fee (but not including brokerage or income taxes). The tests indicated a "fairly strong inverse relationship" between expense ratio and performance. Professors Bower and Williamson conclude, "there seems to be a reasonable basis for concluding that a high expense ratio goes with poor investor experience". It should again be noted here that the venture funds were not included in the analysis.

3.26 The results summarized above are not definite conclusions concerning Canadian mutual funds. They are important, in our opinion, because they represent the findings of an extensive analysis making use of modern techniques. The very fact that the findings are not more definite than they are should encourage further research in this area. We hope that this will be the case, for analytical techniques which rely on criteria other than rate of return are badly needed.

Investment and Trading Practices of Canadian Mutual Funds

3.27 In the course of our studies we collected a considerable quantity of data concerning investments and trading by Canadian mutual funds. These data were helpful to us in the analyses which led to conclusions reached in Chapter IX, on conflicts of interest, Chapter XII, on investment restrictions, and elsewhere in this report. We also reviewed the data to determine whether there were abuses which required attention in connection with the methods of trading used by mutual funds.

3.28 On the basis of our studies we concluded that there are no problems which require legislative attention in the portfolio trading practices of mutual funds. This conclusion relates specifically to mutual fund operations; it was not within our purview to conduct a general analysis of the operations of the Canadian securities markets, nor was it our responsibility to consider the effect of mutual fund investments on national economic policy. However, some of the information we collected may be of interest to future students of both these

questions, and all of it provides relevant background to the matters considered in this report. We therefore summarize our more important findings in the following three subsections. The first two subsections relate to investment practices, considering first changes voluntarily adopted by the industry and second the consequences of constraints on investment practices imposed by the method of operation of mutual funds. The third subsection deals with trading practices. All three subsections are supplemented by an abstract of statistical information in Appendix "B".

(a) Voluntary Changes in Investment Practices and Trading Patterns

3.29 Throughout this subsection general statements are made concerning investments and trading by mutual funds. Few, if any, of these statements are applicable to all Canadian mutual funds. They represent instead our assessment of the general trends present in the Canadian mutual fund industry, considered as a whole. Many mutual funds, particularly those in operation prior to 1962, have not been affected by the various changes described and continue to invest and trade much as they did in the past. The public acceptance of "venture" funds that pursue investment practices which involve a comparatively more aggressive trading philosophy and the acceptance of higher levels of risk in the quest for higher rates of return has, however, resulted in great increases in number and size of mutual funds with such policies. This has occurred both through the organization of new mutual funds and, in some cases, through changes in policy of established mutual funds.

3.30 The statistics quoted in paragraph 3.07 serve to emphasize that the venture funds have grown rapidly in proportion to the industry as a whole. In addition, other mutual funds have begun to follow similar policies in the hope that their rates of return will thereby be increased to match the results of the venture funds. Finally, the Canadian mutual fund industry as a whole has experienced rapid growth, from aggregate total net assets of less than $800 million at the end of 1961 to over $ 3.1 billion at the end of 1968 (including Canadian organized mutual funds and trust company investment funds qualified for sale in Canada). Such a growth rate would change the face of any

industry. While these are perhaps the principal factors that have resulted in the changes in mutual fund investment practices, they are not the only ones. In the following discussion, we allude to a number of other relevant factors.

3.31 Table III-A clearly indicates the major trends in investment practices between 1962 and 1967, when the detailed information compiled by us ends. These trends are towards much heavier investment in equity securities rather than securities carrying fixed rates of return, and towards a larger proportionate investment in securities issued by United States companies. The two trends are closely related, but it is convenient to discuss them separately.

3.32 The move toward increased investments in equities is, in our opinion, a permanent feature of the Canadian mutual fund industry. It is a consequence not only of the emphasis on rate of return, but also of recognition on the part of the industry that it is looked to by investors primarily as a financial intermediary for investment in equities. Long-term protection against inflation through portfolio diversification in the equity market is held out to prospective purchasers by even the conservatively managed mutual funds, except for a few with investment objectives that specifically require investment in other types of securities.

3.33 Table III-A does not reflect one important aspect of the increased emphasis on equities. During the 1950's most equity investments purchased by Canadian mutual funds were "blue chips", securities issued by established companies with good dividend records. The spectacular price increases which have occurred on securities markets in Canada and the United States in recent years have predominantly been in the less seasoned securities, often those of companies commonly regarded as speculative. This has persuaded mutual funds, particularly venture funds, to invest in securities of such companies. These securities are sometimes purchased in private placements of large amounts; a few implications of such purchases are commented on in paragraph 12.26.

3.34 The increased percentage of assets invested in securities issued by United States companies is attributable in part to the same factors that have motivated the move towards greater involvement in the equity markets.

TABLE III-A

ALLOCATION OF MUTUAL FUND ASSETS AT SELECTED DATES 1961-1967

(Dollars in Millions)

	Dec. 1961	June 1962	Dec. 1962	June 1963	Dec. 1963	June 1964	Dec. 1964	June 1965	Dec. 1965	June 1966	Dec. 1966	June 1967	Dec. 1967
Breakdown of Total Net Assets													
Net Cash.........	$ 43	$ 53	$ 44	$ 33	$ 52	$ 63	$ 85	$ 76	$ 123	$ 117	$ 116	$ 125	$ 164
Bonds............	85	83	97	103	109	137	164	176	177	158	171	146	120
Non-Convertible Preferred Stocks.	36	38	43	51	54	60	63	73	88	109	96	97	87
Common Stocks....	607	567	679	791	860	1,001	1,137	1,276	1,480	1,619	1,614	1,991	2,170
Unallocated......	3	4	5	5	2	2	2	3	-	-	-	-	-
Total Net Assets.	774	745	868	983	1,077	1,263	1,451	1,604	1,868	2,003	1,997	2,359	2,541 (c)
Net Cash.........	5.6%	7.1%	5.1%	3.4%	4.8%	5.0%	5.9%	4.7%	6.6%	5.8%	5.8%	5.3%	6.5%
Bonds............	11.0	11.1	11.2	10.5	10.1	10.8	11.3	11.0	9.5	7.9	8.6	6.2	4.7
Non-Convertible Preferred Stocks.	4.7	5.1	5.0	5.2	5.0	4.8	4.3	4.6	4.7	5.4	4.8	4.1	3.4
Common Stocks....	78.3	76.2	78.1	80.4	79.9	79.2	78.4	79.5	79.2	80.9	80.8	84.4	85.4
Unallocated......	.4	.5	.6	.5	.2	.2	.1	.2	-	-	-	-	-
Breakdown of Common Stocks (a)													
Canadian Common Stocks...........	$482	$441	$525	$601	$668	$780	$893	$982	$1,054	$1,059	$997	$1,133	$1,093
Non-Canadian Stocks (b).......	120	120	145	177	192	221	244	294	426	560	617	858	1,077
Unallocated......	5	6	9	13	-	-	-	-	-	-	-	-	-
Canadian Common Stocks...........	79.4%	77.8%	77.3%	76.0%	77.7%	77.9%	78.5%	77.0%	71.2%	65.4%	61.8%	56.9%	50.4%
Non-Canadian Stocks (b).......	19.8	21.2	21.4	22.4	22.3	22.1	21.5	23.0	28.8	34.6	38.2	43.1	49.6
Unallocated......	.8	1.0	1.3	1.6	-	-	-	-	-	-	-	-	-

(a) Total of the breakdown of common stocks is equal to the amounts appearing across the line called "common stocks" in the top section labelled "breakdown of total net assets".

(b) Composed almost entirely of investments in American stocks. Holdings of other foreign securities declined from 3% of equity holdings at the end of 1963 to about 1-1/2% at the end of 1967.

(c) The total of $2,770 million in paragraph 1.21, which includes the total net assets of all mutual funds in Canada, is accounted by adding to $2,541, $54 million for smaller Canadian mutual funds, $11 million for smaller trust company investment funds, $104 million for United States-based mutual funds qualified for sales in Canada and $60 million for the larger mutual funds and trust company investment funds that have failed to reply to the questionnaire or have been unable to provide us with the necessary breakdown for the purpose of this table.

Note: The mutual funds included in this analysis are those defined as large Canadian mutual funds and large trust company investment funds at the beginning of Appendix "B".

The purchase of United States securities has been one of the most controversial aspects of the operations of Canadian mutual funds. A good discussion of the extent of and the reasons for such purchases is contained in the brief submitted to us by the Canadian Mutual Funds Association; that brief also contains comments on the economic questions involved. While these questions are interesting and important, they relate largely to national economic policy; because a consideration of such policy is not within our purview, our discussion is therefore confined to statistics and our explanation of the factors that motivated the investment policy.

3.35 During the period from 1965-1967, the United States securities markets substantially out-performed the Canadian. This attracted the attention not only of professional portfolio managers, but also of the investing public. Some mutual funds were organized specifically to appeal to the interest of Canadians in the United States market; one commenced operations as early as 1957. The largest of these mutual funds, American Growth Fund Limited, had total net assets of $224,849,759 at December 31, 1968. In addition, Canadians made substantial direct investments in mutual funds organized in the United States, or in mutual funds organized in Canada or elsewhere that invest exclusively in shares of United States organized mutual funds. During 1967, such purchases of mutual funds qualified for sale in Canada aggregated about $53 million, and total holdings of Canadians in such mutual funds at the end of 1967 aggregated in excess of $104 million. We believe that significant additional investments were made by Canadians in shares of United States mutual funds not qualified for Canadian sale.

3.36 The considerations that motivated purchases by Canadian investors of shares or units either of United States mutual funds or of Canadian mutual funds which invest exclusively in the United States market were presumably among those that motivated investment managers of other Canadian mutual funds to invest so heavily in the United States market. Starting in early 1965, and until at least the end of 1967 (after which detailed information is not available to us), a substantial portion of new cash inflow from net sales of shares or units by Canadian mutual funds was used to purchase securities of

United States companies. Gains on the sale of such securities were re-invested in the United States market, but only to a limited extent were Canadian securities sold to purchase those of United States companies. Our information indicates that this occurred only in 1967, when net cash receipts from sales, after redemptions, were comparatively low. In that year, Canadian mutual funds appear to have sold between 3% and 9% of their holdings in Canadian securities to invest the proceeds in the United States.

3.37 Canadian mutual fund investment managers were motivated to invest in the United States by certain factors in addition to those that persuaded Canadian investors to purchase shares or units of mutual funds committed to that market by their investment objectives. Insufficiencies in the Canadian securities market are among the most frequently mentioned factors. Two of the insufficiencies given most emphasis are alluded to in the following quotation from the C.M.F.A. brief:

> The supply of Canadian equities available to investors may or may not be adequate in total. The prospect of inadequacy has been suggested by Conway. We regard this as an irrelevant question for the purpose at hand. What is much more certain about the supply of Canadian equities is that the range of industries represented in depth is much more restricted than in other markets. Entire industries are either totally unrepresented or are represented by one or two small companies whose status in their respective industries is marginal. To the extent that portfolio managers seek to include a particular industry in a portfolio, they may be forced to consider U.S. or foreign securities rather than Canadian.

Footnote reference at the end of the second sentence of this quotation is made to the September, 1968 report on The Supply Of, And Demand For, Canadian Equities made as a result of a study commissioned by the Toronto Stock Exchange and prepared by Professor G.R. Conway. This report, referred to herein as the T.S.E. Report, contains a comprehensive discussion of the contention that the supply of Canadian equities is inadequate. The C.M.F.A. brief accords more emphasis to the lack of availability in Canada of securities issued by companies

engaged in certain types of industry, and supports this conclusion by statistics which establish that investment in United States securities by Canadian mutual funds is more heavily concentrated in industries not available in Canada than in industries that are available in Canada.

3.38 Another insufficiency in the Canadian securities markets given considerable emphasis by portfolio managers is the liquidity problem. The implications of the liquidity requirement imposed on mutual funds by the necessity that they be able to effect redemptions on demand by the holder are considered in the discussion below of additional constraints on mutual fund investment managers. Even apart from this necessity, any investment manager is anxious to be in a position to liquidate or accumulate a position in a particular security when occasion demands. This problem is discussed at length in the T.S.E. Report and in the C.M.F.A. brief to us. The latter document states, "it is doubtful whether there are more than 150 listed companies in Canada which have enough stock oustanding for million-dollar blocks to be easily marketable". This fact poses more serious problems for the larger mutual funds than for the smaller ones. It may be augmented by the small number of financial centres in Canada; observation indicates that the range of opinions concerning particular securities at particular times is not as great in Canada as in the United States, a factor that may be detrimental to the operation of supply and demand in the trading markets. Whatever the reasons, it is clear that liquidity poses more problems in the Canadian securities markets than in those of the United States.

3.39 While the insufficiencies outlined above, and others, are of importance, we do not believe they should be regarded as the sole or even the principal explanation for the trend towards investment in the United States markets. Rather, the Canadian portfolio manager and the Canadian investor seek the best investments in Canada and the United States without regard for national boundaries. The lack of availability of certain industries in the Canadian markets necessitates United States investment when such industries seem desirable. Apart from this fact, it is only natural that even when all factors are equal Canadian portfolio managers should invest in securities which

present the greatest prospect for liquidity; when those securities also appear to present the best prospect for profit, as United States securities did between 1965 and 1967, the investment decision becomes even clearer. But if a Canadian security appeared to be the superior investment, most or all Canadian investment managers not constrained by the investment objectives of the mutual fund would be prepared to purchase it, and to accept the possibility that difficulties might be encountered in its liquidation.

3.40 The factors discussed in this subsection are sufficient to account for the trends towards increased equity investment and increased investment in United States securities without regard for the emphasis on rate of return. However, the trends have clearly been accelerated and accentuated by that emphasis; this is particularly true of the tendency towards selection of more junior and speculative equity securities.

(b) Restrictions on Investment Practices Imposed by the Mutual Fund Method of Operation

3.41 References are made in the preceding subsection to the need for liquidity which is dictated by the requirement that mutual funds stand ready to redeem their outstanding shares or units on demand by the holders. Of equal importance to the investment managers are the difficulties consequent upon the fact that almost all mutual funds are continuously engaged in distribution of their shares or units to the public. It is the duty of the investment manager to make the best possible use of the money under his management, and the inability to predict from day to day how much will be added or subtracted is a significant problem in doing so. The problem is essentially one of cash flow, and is present with many other types of investment portfolios but rarely in a form as acute; pension fund and insurance company investment managers, for example, can usually make comparatively accurate predictions as to their cash flow, both receipts and disbursements.

3.42 While industry figures obscure the problems of particular mutual funds, an interesting example of the points made in the preceding paragraph is to be found in the sales and redemptions figures for 1966 and 1967 that appear in Table B-3 of Appendix "B". The dollar amounts of shares or units

sold in those years were $566.7 million and $651.2 million respectively, but net sales after allowance for redemptions were $315.7 million and $200.8 million. Fluctuations in cash flow are often even more severe in particular mutual funds during particular periods; it is hard to state what is the relevant period for this type of analysis, but a few weeks would be more appropriate than a few months.

3.43 The problems outlined above are alleviated by two factors. The first is that, both for the mutual fund industry as a whole and for individual mutual funds, sales almost invariably exceed redemptions when considered over any reasonable period. This means that except in rare cases it is possible to effect redemptions out of the proceeds of new sales. The likelihood that investment will have to be liquidated to meet requests for redemption will be further reduced through implementation of our recommendations in paragraphs 13.89 to 13.101 as to the circumstances in which a mutual fund should be permitted to deliver portfolio securities instead of cash in satisfaction of requests for redemption. Of course, no amount of statistical evidence can establish that the nightmare of the mutual fund industry, a sudden and massive wave of redemptions, will never occur. Our conclusion is only that such an occurrence is unlikely, and that the powers referred to earlier in this paragraph, together with the restrictions on investment in illiquid assets recommended in Chapter XII, and, most importantly, the awareness of the problem on the part of investment managers, will provide adequate protection against it.

3.44 The second factor that alleviates the impact of the constraints imposed on mutual fund portfolio management by the lack of predictability of cash flow is that even if the cash flow were completely predictable, good investment management would require that a significant portion of the portfolio, over and above what is required to satisfy outgoing cash flow, be kept in liquid form. Only thus can the manager ensure his ability to take advantage of favourable investment opportunities as they arise. This is so important that many investment managers, not just of mutual funds, keep a proportion of their assets in cash almost constantly; rarely is a substantial investment

portfolio "fully invested". This means that the necessity to keep a cash reserve which is imposed on the mutual fund investment manager by his cash flow problems does not require him to follow a policy significantly different from that which he would otherwise have followed.

3.45 For the reasons indicated above, we have concluded that no legislative innovations are presently required to deal with cash flow problems in the mutual fund industry. That may not always be true in the future, and both the industry and appropriate administrators should be alert for the development of new and presently unpredictable difficulties in this aspect of the operations of a rapidly growing industry.

(c) Trading Practices of Canadian Mutual Funds

3.46 In the preceding portion of this section we discuss the nature of investments made by Canadian mutual funds. The trading practices through which such investments are made is also an area of considerable interest. Various commentators have expressed concern as to the impact on the Canadian securities markets of the trading practices of institutional investors, including mutual funds. In keeping with the nature of our responsibilities, our analysis has concentrated on mutual funds.

3.47 Canadian mutual funds are constrained in their trading practices by the necessity to avoid having gains made on the sale of securities taxed as ordinary income. Their objective is to show that the policy followed is to invest rather than to trade. For this reason the investment managers attempt to restrict portfolio turnover; many follow a policy against the realization of a capital gain until after the particular securities have been held for, say, a year. In spite of this restriction, the proportionate volume of trading has increased substantially in recent years. Table III-B compares the dollar value of trading during the years indicated with the year-end value of holdings for Canadian, United States and other foreign common stocks. This figure is not directly indicative of portfolio turnover, for the results can be explained in other ways, but the data are of interest in a study of mutual fund trading and the results conform with the more detailed study of turnover discussed below. It will be noted that the level of trading in Canadian equity

TABLE III-B

DOLLAR VALUE OF TRADING IN COMMON STOCKS BY CANADIAN MUTUAL FUNDS
RELATIVE TO DOLLAR VALUE OF YEAR-END HOLDINGS, 1962-1967

(Dollars in Millions)

	1962	1963	1964	1965	1966	1967
Trading in Canadian common stocks	$ 179	$ 241	$ 339	$ 381	$ 439	$ 379
Year-end holdings in Canadian common stocks	525	668	893	1,054	997	1,093
Trading as percentage of holdings	34%	36%	38%	36%	44%	35%
Trading in U.S. common stocks	$ 77	$ 80	$ 114	$ 268	$ 509	$ 1,209
Year-end holdings in U.S. common stocks	125	170	227	412	604	1,039
Trading as percentage of holdings	62%	47%	50%	65%	84%	116%
Trading in other foreign common stocks	$ 14	$ 14	$ 16	$ 8	$ 8	$ 28
Year-end holdings in other foreign common stocks(a)	20	22	17	14	13	38
Trading as percentage of holdings	70%	64%	94%	57%	62%	74%
Total trading in common stocks	$ 270	$ 335	$ 469	$ 657	$ 956	$ 1,616
Year-end holdings in common stocks	670	860	1,137	1,480	1,614	2,170
Trading as percentage of holdings	40%	39%	41%	44%	59%	74%

(a) This figure does not include unallocated common stocks as indicated in Table III-A.

Note: The information relates to large Canadian mutual funds and large trust company investment funds as defined at the beginning of Appendix "B".

securities is relatively stable; the overall trading increase results almost entirely from the trading in United States equity securities. This is confirmed by Table III-C, which shows the relationship between mutual fund trading and total trading in industrial securities on the Toronto and Montreal Stock Exchanges to have remained relatively stable except in the year 1966, when mutual fund trading both in Canadian and United States securities increased substantially relative to total trading in industrial securities.

TABLE III-C

DOLLAR VALUE OF MUTUAL FUND TRADING IN CANADIAN COMMON STOCKS COMPARED WITH TOTAL TORONTO AND MONTREAL STOCK EXCHANGES TRADING, 1962-1967

(Dollars in Millions)

	1962	1963	1964	1965	1966	1967
Trading by mutual funds in Canadian common stocks............................	$179	$241	$339	$381	$439	$379
Twice total dollar value of trading in industrial stocks on M.S.E. and T.S.E.(1)	4,162	4,676	5,924	6,244	5,190	6,961
Mutual fund trading as % of twice total trading...........................	4.3%	5.2%	5.7%	6.1%	8.5%	5.4%

(1) Twice total trading is used because each transaction has a buy and a sell side and all mutual fund purchases and sales are included in the figures for volume of mutual fund trading.

(2) The information relates to large Canadian mutual funds and large trust company investment funds as defined at the beginning of Appendix "B".

(3) Not all of the trading by mutual funds took place on the stock exchanges, since some Canadian securities are acquired or sold in other ways. However, the percentage of trading effected on exchanges is sufficient for the table to be of significance. The Origin of Business Study conducted by the T.S.E. on certain days in May and June, 1968 found the mutual fund business to be 4.4% of twice the total industrial trading.

3.48 Tables III-B and III-C are, as mentioned above, not necessarily indicative of portfolio turnover. During the years in question substantial cash inflow was invested in United States securities, and initial investment of newly received cash should not be regarded as portfolio turnover. Precise calculations of portfolio turnover involve difficulties, of which the treatment of purchases made to invest newly received cash is only one. Another problem is the treatment of shifts between types of securities, for example from debt to equity. For many analytical purposes it is appropriate to regard such shifts differently from turnover of a single class of security, yet often they are difficult or impossible to isolate in the statistical compilation. In some cases sale of securities may be required to meet requests for redemption; as stated in paragraph 3.43, these instances are rare but it is desirable to allow for them.

3.49 To analyze the specific question of relative turnover in Canadian and United States common stocks, we made assumptions that minimized turnover in United States securities and maximized turnover in Canadian securities. We assumed that all new cash inflow was invested directly into United States securities, so that purchases of United States securities to that amount did not represent turnover. We also assumed that all purchases of Canadian common stock were financed by the sale of other Canadian common stocks. We tested the 1967 trading of nineteen Canadian mutual funds on these assumptions, and found that in seventeen of them the turnover was higher with United States than with Canadian securities.

3.50 The level of turnover in United States securities is sufficiently greater than that in Canadian securities to indicate that investment managers may follow different approaches when trading in the two markets. If true, this would be only in small part attributable to the income tax considerations alluded to above, since there is technically no difference under Canadian income tax law between the criteria which determine whether gains on transactions in United States and Canadian securities are to be taxed as income. Of far greater importance is the fact that securities markets in the United States provide better facilities for the accumulation or liquidation of

substantial positions in short periods of time. It is more difficult to attain a high turnover rate in Canada than in the United States, and the difference between the two markets is probably the principal explanation for the different portfolio turnovers.

3.51 The preceding paragraphs relate exclusively to trading in common stocks, for it is this area that has been the focus of attention in the mutual fund industry during the years studied. Both trading with relation to year-end assets and portfolio turnover figures are substantially lower for fixed income securities, including preferred stocks, than for common stocks.*

3.52 While portfolio turnover is of considerable importance in the mutual fund industry, we do not imply that high rates of portfolio turnover should necessarily be subject to criticism; the generation of portfolio transactions for reasons extraneous to investment management, often referred to as "churning", should be criticized in the strongest possible terms, but a high turnover rate consequent upon the search for good investments is not abusive in itself. If the high turnover does not produce good performance, the investment manager may be criticized, but the criticism should be for the poor performance rather than the high turnover. Investment management is a difficult task for which precise guidelines cannot be established; some managers operate best with high turnover, and they should not be prevented from doing so.

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* The statement made in the text is confirmed by the following statistics, which show the annual dollar value of trading in common stocks and in fixed income securities as percentages of total net assets at the year-end. The information relates to large Canadian mutual funds and large trust company investment funds as defined at the beginning of Appendix "B"; convertible securities are treated as fixed income securities.

	1962	1965	1966	1967
Common Stocks.................	31.1%	35.2%	47.9%	63.6%
Fixed Income Securities.......	20.0	10.6	8.5	5.7
Total.........................	51.1	45.8	56.4	69.3

The decline in total trading as a percentage of year-end assets over the period from 1962 to 1965 resulted entirely from the decline in trading in fixed income securities.

3.53 Most of the statistics quoted above are aggregate figures for the industry and conclusions drawn from them would be inapplicable to many mutual funds. Those with conservative investment objectives tend to have lower turnover rates than the venture mutual funds and others which accept a higher degree of risk, and smaller mutual funds tend to have a higher turnover rate than the large mutual funds. We did not find that mutual funds sold through brokers had higher turnover rates than those sold through direct sales forces, although suggestions had been made to us that this would be true because broker-sold mutual funds had to generate sufficient transactions to provide reciprocal business for brokers who sold their shares or units. We were unable to determine whether mutual funds for which brokers were the investment managers had higher turnover rates than other mutual funds of the same size.

3.54 Another aspect of our work related to the influence on the securities markets of trading by mutual funds. Had we found that mutual funds were consistently accentuating price fluctuations by purchasing securities the market prices of which were increasing, or selling securities the market prices of which were decreasing, we would have been seriously concerned. No such finding was made. So far as reliable conclusions could be reached on the basis of available data, our findings were favourable to the mutual fund industry, indicating that trading by mutual funds tends to moderate rather than to accentuate price trends. These indications are based on analyses of the trading data supplied by mutual funds in response to our questionnaires; some of these data are reflected in the summary tables contained in Appendix "B". While isolated instances were found in which mutual fund trading had tended to accentuate the trend of the market as a whole or of particular stocks, there was no evidence that mutual fund trading generally accentuated price trends. A considerable number of cases were found in which mutual fund trading appears to have moderated price trends.

3.55 Two specific studies were conducted to test the more general analyses referred to in the preceding paragraph. In the first of the two studies we selected ten months during which new investments in, or withdrawal of funds from, the Canadian market by Canadian mutual funds aggregated in excess

of 5% of the value of trading on the T.S.E. industrial section. We assumed that mutual fund trading accentuated the price trend when mutual funds were net purchasers while the industrial section was, on average, rising in price or when they were the net sellers while that section was, on average, falling in price. On this basis, the trend was accentuated in only one out of the ten months. The second study was done with respect to individual securities rather than the entire market. It was again found that mutual fund trading was in most cases against the trend, so that they may be said to have exercised a stabilizing influence. It is, of course, clear that the specific responsibilities of a mutual fund investment manager do not include market stabilization, although his mutual fund may suffer from price changes consequent upon destabilizing transactions. There are certain other factors which may contribute to the apparent stabilizing tendency of mutual fund trading. In Canadian securities markets it is often possible to accumulate a substantial position in a particular security only when the price is falling, and to liquidate such a position only when the price is rising. Some sales may have been motivated by the desire to transfer the money to the United States market. Some purchases may have been motivated by the availability of net new money for investment. Whatever the explanations, on the basis of our general analyses and of the two specific studies we think it reasonable to conclude that trading by mutual funds has tended to have a stabilizing effect on Canadian securities markets.

3.56 The preceding summary of our findings with respect to mutual fund trading practices deals only with the principal questions most frequently raised on that topic. Other questions have also been considered, and we have not ascertained that problems exist which require legislative intervention. The interested reader will find a considerable quantity of statistical information in Appendix "B".

The Role of Brokers: Commission Structure and Reciprocal Business

3.57 There are two principal types of relationship between brokers and mutual funds: the sale by brokers of shares or units issued by mutual funds, and the execution by them of transactions for the portfolios of mutual funds. In Canada, the number of dollars involved annually in each relationship

is very substantial, although it is not as large as might otherwise be expected because of the comparatively small percentage of mutual fund shares or units sold through brokers and because of the extent of investments in United States securities, most of which are made through United States brokers. During 1967 brokers sold shares or units of Canadian mutual funds having a value of $153 million, of which the short-term transactions described in paragraph 13.62 accounted for $86 million. We estimate the direct income to brokers from the sale of the remaining $67 million in shares or units to have been between $3.4 million and $4.7 million, after allowance for the portion of the sales charges retained by the distribution companies. In addition, we estimate that Canadian brokers received in excess of $4.5 million during that year as commission for brokerage transactions executed on behalf of mutual funds.

3.58 It is apparent from the dollar figures involved that the relationship between mutual funds and brokers is of considerable importance in an analysis of industry operations. This importance is accentuated by the fact that the bulk of brokerage commissions paid by mutual funds arise from transactions effected through stock exchanges, and therefore are subject to the minimum commission rates prescribed by stock exchanges for their members. These minimum commission rates ordinarily do not differentiate between transactions on the basis of size; the commission levied on a transaction involving $100,000 is 100 times that levied on a transaction involving $1,000 in the same securities at the same price. Certain special adjustments, described below, alleviate the impact of this commission structure for large volume transactions that satisfy certain requirements; apart from such adjustments it is generally recognized that the commissions applicable to large transactions under the schedules of minimum commission rates are unrealistically high as a result of their failure to recognize the economies of size.

3.59 The brokerage industry is a service industry, and it is both inevitable and desirable that investors should deal with brokers who supply the best service. Brokers have traditionally not confined their activities to execution of orders received from the client. Many provide extensive investment advice; some have large departments established solely for this purpose.

In addition, most brokerage firms are prepared to hold their clients' securities in custody and to render similar mechanical and bookkeeping assistance. None of these services is ordinarily charged for separately. All are considered to be paid for by commissions levied on the execution of transactions.

3.60 The increasing participation in the equity markets by large institutional investors, including but not limited to mutual funds, combined with the nature of the commission structure described in paragraph 3.58 has accentuated the importance of the practices described in the preceding paragraph. Institutional investment managers demand extensive investment advice from brokers. They also expect and receive additional services. For example, many mutual funds have the value of their equity portfolios for purposes of the determination of net asset value, computed by brokerage firms; at least one Canadian brokerage firm provides this service for several mutual funds. These and similar services are paid for entirely through the allocation of commission business to the firms involved, and the sophistication of investment managers forces brokerage firms to compete in the provision of services to justify allocation to them of commission business.

3.61 While various services in addition to the execution of portfolio transactions are performed by brokers in exchange for commission business, undoubtedly the most important of these services is the provision of investment advice. The importance of this service has been accentuated by the developments referred to in the preceding paragraph, for institutional investors demand extensive investment advice from brokers. We are unable to comment on the position of other institutional investors, but our observations of the mutual fund industry indicate that management companies place heavy reliance on the advice received from brokers. In many cases the management company retains only a comparatively small investment advisory staff. In these cases investment decisions are made almost entirely on the basis of advice received from brokers; this is particularly true of management companies associated with smaller mutual funds. We comment in Chapter X, particularly in paragraphs 10.25, 10.26 and 10.90 on the relevance of this practice to management fees; for present purposes it is sufficient to note that a decrease in the

amount of advice and opinions received from brokers as a result of a decrease in minimum rates might be a relevant factor to be considered in favour of an increase in management fees, particularly with respect to smaller mutual funds.

3.62 Like other persons who are in a position to give advice that might or might not result in business for themselves, brokers are subject to temptation that they will shape their advice to produce business. The specific danger is that they might give advice designed to persuade their clients to buy or sell rather than to hold. While we have found nothing to indicate that the advice given by brokers is affected by this consideration, it concerns us that more management companies have not developed staffs capable of giving investment decisions the careful analysis they deserve, and of providing the fundamental research that is necessary for a successful long-term investment programme.

3.63 Other types of problems can arise from the use of commission business to pay for investment advice. For example, a mutual fund or other institutional investor associated with a brokerage firm and committed to effect all its transactions through that brokerage firm may suffer because investment advice will not be available to it from other brokerage firms. Further, all institutional investors are aware of the availability of this type of service, and are also aware that as a result of the minimum commission rates this and other services provide the only form of competition available to brokerage firms. This means that the investment manager must accept investment advice or other services if he wishes to take advantage of the competition; in other words, he can obtain what amounts to a commission discount, but only in the form of services. These problems, combined with those alluded to in the preceding paragraph, are matters of considerable concern in the securities industry.

3.64 In the context of mutual funds, there is one major problem in addition to those mentioned above. The management company of a mutual fund undertakes to supply investment management for a fee. For it to receive advice from brokerage firms in exchange for commission business executed on behalf of the mutual fund constitutes an additional benefit paid for by the mutual fund.

The management company, which has undertaken to provide research and investment advice, in fact receives a considerable amount of it at the expense of the mutual fund, over and above the management fee. Ideally, the benefit of any reduction, direct or indirect, in the commission charges should enure to the mutual fund rather than the management company. We are aware of no way in which that ideal could be attained on a basis consistent with the minimum commission structure and, for reasons indicated below, we do not feel that we can appropriately recommend changes in that structure. In paragraph 10.90 we recommend instead that the extent of reliance on advice from brokers be taken into account in the determination of the reasonableness of management fees.

3.65 The use of brokers as a channel of distribution for shares or units of mutual funds, combined with the pressure to provide them with maximum compensation for such sales, has resulted in the allocation of portfolio transactions to compensate brokers for the sale of shares or units. The extent of this practice differs between organizations, but it is common practice for brokers who sell mutual fund shares or units to be allocated portfolio transactions for execution in order that the commissions will provide additional compensation. In some cases, this is done on the basis of an understood formula; a frequently used formula is that a dollar in portfolio transactions is allocated for every dollar's worth of shares or units sold. In other cases, the practice is not rigid, and with some distribution companies, it is not used at all. Where it is used, the commission business is received by the broker as compensation in addition to his portion of the sales charge.

3.66 The problems involved with the allocation of portfolio transactions as additional compensation for sales are more acute than those involved in the use of reciprocal business as compensation for investment advice. The participants in the mutual fund may benefit from such advice, if it improves the quality of portfolio transactions; it is hard to see any benefit to them in the sale of further shares or units. The management company may be subject to a temptation to generate portfolio transactions unnecessarily in order to compensate brokers for the sale of shares or units. In addition, there is the potentiality of abuse in the receipt by brokers of additional compensation for

the sale of shares or units which they do not disclose to their clients. For all these reasons, we consider the allocation of portfolio transactions as compensation for the sale of shares or units to be an undesirable practice. However, for reasons indicated in paragraph 3.69 we do not feel that it should be prohibited by statute; apart from the problems there mentioned, such a statute would be difficult or impossible to enforce. Instead, we recommend in paragraph 10.90 that the extent of use of reciprocal business to provide additional compensation for the sale of shares or units be considered in the determination of the reasonableness of sales charges.

3.67 In its Public Policy Report* the Securities and Exchange Commission in the United States made findings substantially similar to the conclusions set out in the preceding paragraphs of this section. The S.E.C. further found that the use of portfolio transactions as compensation for services, usually called "reciprocal business" had been developed to a highly organized pattern in the United States through the use of "give-ups". Under a give-up, the broker who effects a portfolio transaction surrenders a portion of the commission, on instructions, to another broker. For present purposes, it is not necessary to trace in greater detail the position in the United States; it has become one aspect of a major dispute over commission structures and sales charge arrangements. The use of give-ups has been restricted and stock exchange commission rates on large transactions have been lowered.

3.68 In Canada, the use of reciprocal business as compensation for investment advice is very common. Its use to compensate brokers for the sale of shares or units has not developed to the extent used in the United States. Applicable stock exchange rules are one responsible factor. Another factor is that the percentage of sales of shares or units effected through brokers is much smaller in Canada, so that there has not been as great pressure to extend the practice of giving reciprocal business for sales. Give-ups are little used in Canada, although they have developed to a limited extent; most reciprocal business is effected by orders placed directly with the broker to

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be benefited. Stock exchange rules have also prevented the use by Canadian distribution companies of portfolio transactions with United States brokers to provide reciprocal business for Canadian brokers.

3.69 In spite of our concern about undue reliance by mutual fund management companies on investment advice paid for with reciprocal business, and in spite of our adverse conclusion on the use of reciprocal business to compensate brokers for sales of shares or units, we do not believe that mutual fund management companies should be prohibited from these practices. We regard them as a natural result of the economic and regulatory environment. To prohibit them would be difficult because competitive considerations would motivate management companies and brokers to find an alternative technique to accomplish the same objectives; even if the prohibition were succesful, the result would be a windfall to the brokerage community, for brokers would receive commissions at the same rates but would not have to provide reciprocal services. The true remedy for the problems in this area lies in revision of the minimum commission structure.

3.70 Steps have already been taken by the Canadian stock exchanges to reduce the anomalies inherent in the minimum commission structure as applied to large volume transactions. These steps are here described with reference to the Toronto Stock Exchange; substantially similar arrangements have been implemented by other Canadian exchanges. In 1968 the Toronto Stock Exchange revised a procedure for block transactions that had been in effect for some years and was heavily used by mutual funds. The procedure in effect prior to the revision permitted single transactions involving between \$100,000 and \$250,000 to be effected off the Exchange floor at three-quarters of the regular commission, and those involving in excess of \$250,000 to be so effected at one-half of the regular commission. The revised procedure allows only a 30% commission reduction, but that reduction is applicable where the total value of purchases or sales of a particular security made within five consecutive trading days, whether or not effected on the floor of the Exchange, exceeds \$100,000. The new procedure is popular with, and heavily used by, mutual fund investment

managers. They agree that it lowers commission costs and also feel that it has made a contribution to liquidity by returning large transactions to the floor of the Exchange.

3.71 Experience has not yet indicated what effect the new procedure for volume discounts will have on the extent of use of reciprocal business to compensate for services, especially investment advice, and for the sale of shares or units. It may be that the new procedure will constitute an adequate resolution of the problems. In addition, we recognize the importance to stock exchanges of the minimum commission structure and that extensive changes in that structure could have a fundamental effect on the operations of the securities industry. The implications of adjustments in this area go far beyond mutual funds and investment contract companies, and we do not think such adjustments should be recommended by this Committee. Most of the Canadian stock exchanges have stated in letters to us that the entire volume discount position is being kept under continuing review. We urge that the appropriate administrative and legislative authorities also consider the question after further experience under the 1968 revision of the volume discount procedure. Developments in the United States are also of direct relevance to the Canadian situation. So long as there is wide-spread reliance by mutual fund management companies on allocation of portfolio transactions as compensation for services rendered, the problems discussed above will in our opinion continue to exist.

Management Companies as Stock Exchange Members, and Vice Versa

3.72 A controversial topic closely related to that of stock exchange commission rates is whether mutual fund management companies should become members of stock exchanges in order to reduce commission costs. This step has at the time of writing been taken by only one Canadian management company, A.G.F. Management Limited. A wholly-owned subsidiary of that company, A.G.F. Management, Inc., has become a member of the Pacific Coast Stock Exchange in the United States. Since a very large proportion of the portfolio transactions of mutual funds managed by A.G.F. Management Limited are effected in the United States, substantial savings can be realized in this way.

A.G.F. Management Limited has agreed to reduce the management fee charged the mutual funds it manages by an amount equal to the "net income" realized by A.G.F. Management, Inc. from transactions for these mutual funds, less United States withholding taxes applicable if that amount were paid to the parent company by way of dividends.

3.73 It is apparent that substantial savings can be realized if the management company of a large mutual fund is able to effect transactions directly on the stock exchange and thereby avoid the minimum commission structure. To the time of writing, Canadian management companies have not expressed strong interest in such a step. We think there are three reasons for this: the expense involved in the acquisition of a membership or seat on a stock exchange; the fact that transactions could no longer be allocated to brokers as compensation for services; and the lack of anonymity in the implementation of transactions through the management company. As mutual funds grow larger and minimum commission structures become more realistic, the former two factors may disappear. The lack of anonymity may be more difficult to resolve, but in our opinion this would not alone be sufficient to prevent management companies from becoming stock exchange members.

3.74 We wrote to each of the Canadian stock exchanges to inquire as to their policies should applications for membership be received from mutual fund mangement companies. Most replied, and each of those which replied indicated a negative opinion although that opinion was not in all cases expressed as a considered policy decision. Two reasons were advanced. It was felt that brokers should be prepared to deal with all aspects of the investment business; only thus are they able to contribute to the maintenance of a market place that will serve a wide range of interests. Management companies, it was suggested, would not be able to do this. Secondly, concern was expressed as to the application of the exchanges' regulatory and disciplinary powers to a management company, particularly if that company was a public company.

3.75 It is anomalous that mutual fund management companies are prohibited from the acquisition of stock exchange membership, while brokerage firms are permitted to become mutual fund management companies. The two

arguments referred to in the preceding paragraph do not convince us that the prohibition is justified. The only arguments to that effect which we find at all persuasive should be equally effective as arguments in opposition to brokers becoming management companies of mutual funds. These arguments are considered in the next paragraph.

3.76 In any case where the management company is also a stock exchange member and will make a profit by effecting portfolio transactions for the mutual fund, difficulties are present. There is a conflict of interest on the part of the management company in the determination of trading decisions. The fact that commission business is assured and cannot be taken away by another broker through superior research advice reduces the motivation to generate investment advice. The corollary of this is as indicated in paragraph 3.63, that where a mutual fund's transactions are all effected through one broker, there is no reason for other brokers to supply investment advice. Finally, apart from the other problems, it is difficult or impossible to make adequate disclosure of the significance of the arrangement. For example, the prospectus of one mutual fund which has a brokerage firm as its management company and pays that firm a management fee of 1% of its average total net assets per year, briefly states that all transactions for the mutual fund will be executed by a wholly-owned subsidiary of the brokerage firm which holds its stock exchange membership. No suggestion is made that any portion of the profit will be refunded, as contemplated by the arrangement described in paragraph 3.72.

3.77 The problems described above, which arise in any case where the same organization acts as management company and as broker regardless of which is its principal business, may differ in scope but do not differ in kind from the general problems described in the preceding section which arise from the use of reciprocal business. There are other problems inherent in the combination of the management and brokerage functions, involving, for example, the potential use of the mutual fund to purchase securities the broker is unable to sell elsewhere. The latter problems are, if anything, more serious for the brokerage firm which is also a management company than for the management

company which holds a stock exchange membership. Such problems would be alleviated, but not eliminated, through implementation of the recommendations in Chapter IX.

3.78 Because the problems described in paragraph 3.76 differ only in scope from the general problems involved in the use of reciprocal business, we have concluded that the reasons which persuaded us not to make specific recommendations in the latter context are also relevant here. We therefore make no recommendation to limit the acceptance by brokerage firms of portfolio transactions for mutual funds managed by them, although we feel that the entire situation should be kept under continuing scrutiny by administrative authorities.

3.79 We have also decided to make no recommendations on whether management companies should be admitted as stock exchange members. This, like the minimum commission structure, is a topic with far-reaching implications in the securities industry. Management companies are only one type of financial institution that might wish to obtain memberships on stock exchanges, and we think the entire question should be considered in the wider context.

CHAPTER IV

ADMINISTRATIVE PROBLEMS IN MUTUAL FUND OPERATIONS

4.01 In Chapters II and III we discuss the two most important aspects of mutual fund operations, the distribution of shares or units and the provision of investment management. While these activities dominate the industry, no study of mutual funds would be complete without an analysis of the administrative framework that provides the context within which they are carried on. Indeed, with mutual funds as with other financial institutions that cater to large numbers of investors, administration is of particular importance. Procedures must be arranged so that many accounts can be efficiently administered at minimum expense. The possibility exists that these procedures might benefit the financial institution concerned at the expense of the investor. Certainly they should be carefully reviewed, both to assist in an understanding of the distribution and management functions and to ascertain any possible unfairness to investors.

4.02 Few if any of the matters discussed in this chapter would be considered by even the most knowledgeable of mutual fund investors. Their natural assumption is that administrative aspects of the mutual fund are so arranged as to facilitate the purchase of shares or units and the investment by the mutual fund of the proceeds of sale with maximum fairness to all concerned. We have concluded that this is a justifiable assumption, and that rules concerning administrative arrangements should be applied to confirm the accuracy of the assumption. We do not regard such rules as restrictive; rather, they

provide a common framework of operations. They do not impede but assist the development of competition among mutual funds in the vital functions of distribution and investment management. They therefore are of benefit both to mutual funds and to their investors.

4.03 In this chapter we briefly describe the principal difficulties to be resolved in the administration of mutual funds, all of which are considered at greater length in later chapters. For explanatory purposes and to emphasize the extent to which these problems are attributable to the scope of mutual fund operations, comparative references to investment clubs are made throughout the chapter. The discussion is designed only to indicate the nature of the problems that must be resolved, and is correspondingly brief.

Determination of Investment Policies and Decisions

4.04 The organizers of an investment club almost certainly have a common approach to investment policy; if they do not, they ought not to belong to the same club. One of the earliest organizational matters to be attended to, preferably before any investment decisions are made, is the reduction to written form of this common policy. The written statement will ordinarily not only specify investment objectives, including a reasonably precise statement of the degree of risk to be undertaken, but should also spell out the investment practices that will be available to assist in the accomplishment of those objectives. If there are to be restrictions on the types of investments to be purchased, they should be indicated. Other relevant matters include whether the club is or is not to borrow, effect short sales, and write or purchase puts and calls.

4.05 The next decision to be made by the investment club is how decisions are to be made. Any except the smallest club will ordinarily delegate at least emergency powers to an individual or committee, in order to enable quick action to be taken when necessary between club meetings. A larger club will often delegate very wide powers to a small group, and careful consideration must be given to the extent to which decisions of that group will be subject to review by the membership.

4.06 The same questions concerning investment policy must be resolved in the operations of a mutual fund. They arise, however, in a different context. Ordinarily the organizers of the mutual fund arrange in advance by contract (in the case of an incorporated mutual fund) or by trust agreement (in the case of an unincorporated mutual fund) to confer on the management company, which is controlled by them, the power to make investment decisions for the mutual fund. With incorporated mutual funds, and sometimes with unincorporated mutual funds, power is reserved to the board of directors, governors, or their equivalent to review and reject the management company's decisions. This power is rarely exercised; almost invariably in practice the management company has full authority. This means that there is no formal review of its decisions; nor is there ordinarily any realistic procedure available whereby shareholders or unitholders can determine that the services of a management company are inadequate and replace it with another management company. The extent to which shareholders or unitholders may review management decisions and the manner in which they may replace the management company are discussed in Chapters VI and XI respectively.

4.07 The scope of the management company's discretion in the determination of investments to be made by the mutual fund is restricted by the statement of investment objectives and practices embodied in the prospectus. This also is created by the organizers of the mutual fund, and is designed so as to appeal to a segment of the investing public. It usually contains a general description of investment objectives, with an indication (often very vague) of the level of risk that will be accepted in the attainment of those objectives. It also describes, in more specific terms, the practices that may or may not be used, such as borrowing, short selling, and similar practices. Its contents might well be similar to the corresponding statement prepared by an investment club.

4.08 While the statement of investment objectives and practices acts as a constraint on the investment decisions taken by the management company, in most mutual funds the management company can as a practical matter amend the statement without consent of the shareholders or unitholders. Even in instances

where amendments require consent of the shareholders or unitholders, this consent can readily be obtained through proxy solicitation. Provided that the amended statement is satisfactory for prospectus purposes to the administrators in provinces where shares or units are being sold, the shareholders or unitholders cannot ordinarily prevent such amendments although they can redeem their shares or units if they disapprove. The contents of statements of investment objectives and practices, and procedures for their amendment, are discussed in Chapter XII.

Relationships Between the Management Company and the Mutual Fund

4.09 Problems concerning the relationship between the management company and the mutual fund arise in the context of a mutual fund which rarely have any equivalent with investment clubs. Perhaps the most important is the size, manner of determination and method of payment of the management fee. Here, again, the organizers have virtually unfettered discretion within the limits imposed by securities administrators through the exercise of their discretionary authority. Ordinarily the fees are determined as percentages of average total net assets, but technical problems arise in the computation and manner of payment even of this comparatively simple type of management fee. Some mutual funds pay management fees that fluctuate with the rate of return on the mutual fund portfolio as compared with that on a portfolio composed of the securities that make up an accepted market index; the technical problems that arise in connection with such fees are considerably more serious than those with the fee computed as a percentage of average total net assets, and are accompanied by difficult questions of principle. These problems and questions are considered, and recommendations are made, in paragraphs 11.39 to 11.55.

4.10 Another problem in the relationship between the management company and the mutual fund which ordinarily has no equivalent in the context of investment clubs is the allocation of expenses between the two. Most investment clubs would deduct expenses of operation from the assets of the investment club,

but with mutual funds these expenses are in large part covered by the management fee. The extent to which this is true differs considerably between management companies, as a result of which comparisons of management fees may not be a relevant indication of comparative management expenses.

4.11 A third problem in the mutual fund context that is not ordinarily present with investment clubs arises from the fact that the organizers of the mutual fund consider its management and distribution contracts to be their property. As explained in paragraphs 1.04 to 1.08, such contracts provide their entrepreneurial reward for the creation of the mutual fund, and a substantial initial investment may be required before the return under them becomes worthwhile. Having made that investment, the organizers feel entitled to look to the contracts not only as a source of revenue but as property that may be disposed of. A number of transactions involving the transfer of contracts have occured in Canada; in some cases, substantial profits have resulted. Another indication of the proprietary attitude to management and distribution contracts is that in several cases the controlling shareholders have made a distribution to the public of an interest in the management company. Shareholders or unitholders of the mutual fund are rarely consulted concerning any of these transactions, although they may have purchased in reliance on the quality of the existing management company. Recommendations as to the procedures applicable on transfers of management and distribution contracts, and on sale of control of the management and distribution companies, are made in paragraphs 11.16 to 11.26; the problems which arise when a management company "goes public" are considered in paragraph 11.06.

4.12 All of the problems discussed in this section involve a difficult question as to the relationship between a mutual fund and its shareholders or unitholders. The mutual fund can well be regarded as a vehicle whereby money is managed for a fee and may be withdrawn at any time by its owner. On the other hand, many consider mutual funds, whether or not incorporated, to be operating entities that retain outside management on a fee basis. The difference between the approaches is irrelevant to most aspects of mutual fund operations, but crucial to problems that involve arrangements between the management

company and the distribution company, and the mutual fund. If the mutual fund is simply a vehicle for money management, the management and distribution companies should be accorded wide authority although the shareholder or unitholder could redeem if dissatisfied. If the mutual fund is regarded as an operating entity, more authority in its operations should be entrusted to its shareholders or unitholders. This question is returned to frequently throughout the report, and is discussed at some length in Chapter VI.

The Issuance and Redemption of Shares or Units

4.13 The organizers of an investment club will ordinarily wish to create rules and procedures to govern the addition of money to, and its withdrawal from, the portfolio of the investment club. Two principal questions are involved: the limitations subject to which participants may effect additions or withdrawals, and the arrangements to be used in the determination of the value of their interests from time to time. Both problems would be easily resolved if all participants followed identical patterns, adding or withdrawing money simultaneously and in identical amounts. If more flexibility is to be provided for the participants to make use of the club to serve their own financial requirements, by adding or withdrawing money when they think fit, then the mechanical and administrative problems to be resolved are considerably greater.

4.14 If participants in an investment club are to be permitted to add cash to the portfolio to increase their holdings, and not all of them add equal amounts of cash at the same time, the initial question to be resolved is that of valuation. A number of assumptions must be made if the dollar value of a portfolio of investments is to be determined with precision; the nature of the assumptions and the problems they involve are discussed in Chapter XIII. The usual procedure is to rely on market value and to devise alternative procedures for the valuation of investments for which no market value is readily available.

4.15 Even in the context of an investment club, agreement on portfolio valuation procedures is not alone sufficient to resolve the second of the two questions referred to in paragraph 4.13. A decision must be made as to whether the value of a participant's interest from time to time should differ depending upon whether he is withdrawing money from, or adding it to, the

portfolio. If he proposes to withdraw money it could be said that the amount paid to him should reflect the brokerage and administrative costs involved in the payment. The argument would be that if securities must be sold to pay him the money, he, rather than the other participants, should pay the expense involved. Similarly it could be argued that the brokerage and administrative costs involved in the receipt of new money should be reflected when money is added for investment. Acceptance of these arguments would mean that the redeeming participant would receive less than the proportionate worth of his interest in the portfolio, and that the person adding new money would receive an interest in the portfolio worth less than the money added. The participants in the investment club must decide whether to accept these arguments and, if so, the amount of the increase or deduction to be made.

4.16 The question of the limitations subject to which participants may effect additions or withdrawals raises more problems for resolution. It may take some time to invest money received, or to raise money to pay on a withdrawal. The time factor may be greater for larger amounts. Because of this, and because the participant's interest in the investment club is ordinarily computed from the day of his payment to the club regardless of whether it is effectively invested on that day, the participants may wish to limit by amount or frequency or both the extent to which additions and withdrawals are made. Another approach to the question would be to require that a period of notice be given prior to an addition or a withdrawal.

4.17 In the procedures on issuance and redemption of shares or units, the mutual fund faces all the problems outlined above with respect to investment clubs, but in magnified form; and it also faces a number of additional problems which arise because of the public distribution of shares or units and the requirement that redemptions be effected on demand by the holder. The price received by the mutual fund for shares or units issued is usually the same as that paid by it for shares or units redeemed and no allowance is made for brokerage and administrative expenses incurred on issuance or redemption. The prices paid or received by the mutual fund are, of course, not necessarily the same as those paid or received by the investor for they do not reflect sales

or redemption charges levied by the distribution company. Rarely is there any specified limit on the size or frequency of redemptions or purchases, although some distribution companies purport to restrict unduly large or frequent transactions on a discretionary basis. The merits of the prevailing practices on these matters are considered in Chapter XIII.

4.18 With respect to valuations, the public nature of a mutual fund aggravates the potential problems that can arise. An investment club, by its very nature, has considerable flexibility to adapt to circumstances; its participants are usually personal friends. This is not true of mutual funds, which must establish precise procedures for issuance and redemption of shares or units. Abuses can in these circumstances arise in a number of ways. If, as is often true, the price computed on one day is effective the following day (in the case of some mutual funds, the price is effective even longer) a sophisticated investor may make a substantial and certain profit on days when the market as a whole is rising. Usually, when the market is rising the value of a mutual fund's shares or units is also rising, and the investor has only to purchase shares or units at the preceding day's price and present them for redemption at the price quoted on the day of purchase to make (subject to sales charges) an instantaneous profit. This possibility, which arises from the practice called "backward pricing", is also discussed in Chapter XIII.

4.19 Another difficulty with mutual funds that is not present to the same extent with investment clubs is the lack of predictability in cash flow. Sales and redemptions of shares or units both fluctuate in volume from time to time, with consequent problems in the conduct of an investment programme. Mutual fund investment managers, unable to predict with certainty what their cash flow will be, are handicapped in their endeavours to formulate investment programmes. This problem is discussed in paragraphs 3.41 to 3.45.

Custody of Assets

4.20 To the newly formed investment club, custody is not usually a difficult problem. Arrangements can usually be expeditiously made with a custodian or broker to hold securities acquired by the club. Such a matter may be regarded as completely routine and may therefore be entrusted to the member who

is to assume the responsibility of club treasurer. Nor does custody of the instruments which represent members' participations in the club ordinarily present a serious problem. There may be no such instruments; the secretary or the treasurer may be relied upon to maintain records that indicate the position of each club member from time to time. That these aspects of club operations may be so lightly regarded does not mean they are unimportant; it only means that members are all prepared to trust the individuals to whom responsibility is delegated.

4.21 The question of custody is more complex in the context of a mutual fund, which is an enterprise organized for profit by persons who are usually unknown to the shareholders or unitholders. In the organization of the mutual fund arrangements are made for the custody of its portfolio securities. While the custodian is usually an independent bank or trust company, its responsibilities are spelled out in the agreement with it, and there may be a temptation for the organizers to negotiate the terms of that agreement with a view to the provision of maximum flexibility. In most cases the organizers are anxious to establish safeguards, but in a few cases the procedures to be followed in order to obtain the release of securities from custody are very simple.

4.22 Regardless of the complexity of the safeguards established, few custodian arrangements would pose serious obstacles to two or more senior officers of the management company prepared to collaborate in the theft of the securities owned by the mutual fund. Perhaps a more likely procedure to be engaged in by the unethical management company is to cause the mutual fund to make investments designed for the company's benefit. Few, if any, custodian arrangements require the custodian to subject the transactions to any type of scrutiny, and the unethical management company might be able to effect with comparative ease a series of transactions that would be of benefit to it. We discuss the custody of mutual fund assets and transactions motivated other than by the best interests of the mutual fund in Chapters VIII and IX respectively.

4.23 Another question of custody concerns the instruments that represent participations in the mutual fund by shareholders or unitholders. Particularly in cases where the investment is made under a periodic payment plan, with investments at regular intervals over a period of time, the certificates

that represent the shares or units acquired are frequently held by a custodian. Again, the custodial arrangements are made by the organizers of the mutual fund, and they are often made in such a way that in any case where the shares or units must be voted, they will be so voted as to support the position of the management or distribution company. To the extent that voting rights are conferred on shareholders or unitholders, consideration must be given to whether the custodians should be required to look for instructions to the investors on whose behalf they hold shares or units. These questions are also discussed in Chapter VIII.

4.24 The final aspect of the question of custody concerns incoming money for the purchase of shares or units. In the investment club, this is usually deposited directly in the club's account. That is rarely the case with mutual funds. It is in the best interests both of the purchaser and of the other shareholders or unitholders that such money should be added to the assets of the mutual fund as expeditiously as possible. Yet, particularly in cases where the sale is made through a salesman in the field and the money paid to him, the mechanical problems involved in the transfer of money to the mutual fund are such that some delay is inevitable. A distribution company in need of money could easily lengthen this period and make use as working capital of the resultant "float" of money paid for shares or units but not yet invested in the mutual fund. It could also retain the interest on the money for the intervening period. We are aware of one instance in which both of these practices occured, and in which serious results for all concerned were only narrowly averted. There are many other instances in which an appreciable delay before money is received by the mutual fund occurs frequently.

Continuing Disclosure to Participants

4.25 The members of an investment club must decide the extent of information they wish to receive on a continuing basis concerning the club's activities, and the manner in which that information is to be provided to them. This decision involves a determination of the extent to which the desire for information should outweigh the cost of supplying it. Two types of information are involved: that which relates to the investment club itself, and that which

relates to the interests of the members in the investment club. Members might well decide to content themselves with relatively little information on each point; oral reports at club meetings coupled with an annual statement might be regarded as adequate.

4.26 In the context of mutual funds the public nature of the organization and the fact that shares or units are in continuous distribution to the public complicate the problems of continuing disclosure as they do all other problems discussed in this chapter. With respect to information as to the operations of the mutual fund, it is difficult to distinguish between the information that should be provided for the new purchaser and that which should be provided for the existing shareholder or unitholder, although it is obvious that the rules as to when the information is to be supplied must be different in the two cases. Our conclusions on this and related questions are set out in Chapters XIV and XV.

CHAPTER V

DEFINITION AND CAPITAL STRUCTURE OF MUTUAL FUNDS

5.01 Crucial to the legislative scheme proposed in this report is the belief that mutual funds are a class of financial institutions and should be regulated as such. This belief is one we fully accept, and the eleven governments which appointed us as a committee impliedly adopted it through the nature of the responsibilities they conferred upon us. Yet the term "mutual fund" is sometimes used today to refer to closed-end investment companies as well as to the organizations we regard as mutual funds, and that usage was common in the past. The term has developed a narrower meaning through popular usage in recent years, although no general consensus has been reached as to precisely what organizations are to be regarded as mutual funds. This must be decided if the discussion in following chapters is to be meaningful; and an exact definition of the term forms an essential part of the legislative scheme which we concluded to be necessary. In this chapter we build on the general description of mutual fund operations provided in Chapter I to arrive at a definition of mutual funds.

5.02 In Chapter I we describe the regulations to which a Canadian mutual fund is presently subject. These are determined in part by the form of organization of the mutual fund. Every mutual fund qualified for public sale in Canada is organized either as a company or as a trust, and is therefore subject to the law applicable to companies or to trusts. Other forms of organization, such as the partnership, could be adopted but each would involve the acceptance of the legal requirements applicable to organizations of that type. The principal regulatory implications of organizing as a company or as a

trust are summarized in paragraphs 1.50 to 1.58. Corporations act provisions constitute detailed codes of procedure; few of them, and those only to a limited extent, make allowance for the problems and practices that are peculiar to mutual funds. The trustee acts are much less detailed and leave very considerable scope for determination of procedural arrangements by the trust agreement or other instrument which creates the trust.

5.03 We have concluded that the principal regulatory requirements applicable to mutual funds should be uniform regardless of the form of organization adopted in a particular case. For convenience, and because of the diversity of possible forms, the approach adopted in this report is to recommend positive requirements for application to all mutual funds, as defined; the definition propounded in the next section includes companies, trusts, partnerships or other types of organization which possess the essential attributes of a mutual fund. In subsequent sections of this chapter we consider the equity structure of mutual funds; that discussion is the only important instance in this report where we have found it necessary to make detailed reference to existing legal requirements applicable to mutual funds organized in a particular way. This is because certain of the statutory provisions applicable to incorporated mutual funds are so inconsistent with our conclusions that special reference to them seems essential.

Definition of a Mutual Fund

5.04 Two principal questions must be resolved in the formulation of a precise definition of the term "mutual fund". The first is the nature of the activity which distinguishes mutual funds from other financial institutions. The second is whether financial institutions which carry on that activity in addition to other activities should be regulated as mutual funds. All financial institutions provide for the pooling of money received from a number of participants; money is raised by the issuance of instruments, which may be called certificates, securities, contracts, agreements of deposit or by other names, and is pooled for investment in accordance with the nature of the business of the institution concerned. In most cases, the instrument issued constitutes a debt or

fixed obligation of the financial institution; the organizers or equity participants receive the benefit of any excess earnings on the money raised over the amount that must be paid to the holders of the instruments and expenses of operation. In some of these cases the equity participants must pay a portion of the excess earnings to the debt-holders for competitive reasons; examples include dividends on life insurance policies and additional credits on investment contracts. In spite of this, there is a fundamental difference between these instruments and those under which losses and gains experienced by the portfolio are automatically passed through to the participants. It is this difference which distinguishes the instruments (shares or units) issued by a mutual fund from those issued by other financial institutions. The mutual fund share or unit does not constitute a debt or fixed obligation; its value fluctuates directly with the value of the proportionate interest which it represents in the mutual fund portfolio.

5.05 Mutual funds are not the only financial institutions that issue equity instruments. Every financial institution has such instruments outstanding, usually in the form of shares, which might or might not be in public hands. The difference between mutual fund shares or units and the equity instruments issued by other financial institutions is that the holders of the latter can only realize on them through sale to others at the best available price, or (in some cases) through redemption by the issuer at its own option. The issuer cannot be required to redeem the shares on demand by their holders, nor can the holders, when the shares are sold or redeemed, count on receipt of a price determined solely by reference to the proportionate interest they represent in the assets of the issuer, although that may be a relevant factor in the determination of price. By contrast, a holder of a mutual fund share or unit is entitled to receive, on demand, an amount determined by reference to the value of his proportionate interest in the mutual fund. We have concluded that this is the distinctive feature of the mutual fund share or unit and that the issuance of such instruments is the activity which distinguishes mutual funds from other financial institutions.

5.06 The conclusions set out in the preceding paragraph lead naturally to the further conclusion that if any organization has outstanding instruments which the holders can require it to redeem at an amount determined by reference to the value of the proportionate interests the instruments represent in the assets of the organization, it is a mutual fund. Subject to certain exceptions set out in the next section, that is the definition we propose. This definition may seem obvious, but it has a number of important implications. One arises from the fact that reliance for definitional purposes on the nature of the instrument issued makes irrelevant the nature of the business carried on by the organization. For example, an industrial company the principal asset of which was its plant and equipment, might decide to provide shareholders with the right to demand redemption of their shares at a price computed by reference to the value of the proportionate interest they represented in the company's assets. To confer this right would, however, make the shares into mutual fund shares and under our proposed definition their issuance would make the industrial company a mutual fund. As a mutual fund, the company would almost certainly be in violation of the investment restrictions proposed in Chapter XII for application to mutual funds, because of the concentration of its holdings in illiquid assets and probably also because it owns real estate. The result would be that the industrial company could not provide such a right in its shares, a result that we think desirable because of the valuation and liquidity problems that would be involved.

5.07 Our answer to the first question raised in paragraph 5.04, that what distinguishes mutual funds from other financial institutions is the issuance of mutual fund shares or units, leads naturally to the resolution of the second question. Any entity which issues such instruments is a mutual fund, and that would include any other financial institution regardless of the nature of its other activities. Other financial institutions that decide to sell instruments having this characteristic establish segregated or separate funds by reference to which the redemption value is computed; under our proposed definition, such a fund rather than the financial institution which created it would be the mutual fund. This point is explored further in later sections of this chapter.

5.08 Our answer to the second question raised in paragraph 5.04 is not solely a result of our decision that the nature of the mutual fund share or unit is a convenient basis for a definition. The discussions of specific financial institutions later in this chapter indicate in greater detail the reasons for our belief that other financial institutions which issue instruments that carry the same rights as mutual fund shares or units should, in that aspect of their operations, be subject to regulations similar or identical to those applicable to mutual funds. These reasons may be briefly summarized. Many of the regulations recommended in this report are designed to resolve problems attributable to the method of operations of mutual funds, problems not present with the activities traditionally carried on by other institutions and therefore not dealt with by the regulatory structures applicable to them. In addition, we do not think that either the traditional mutual funds or their competitors should be put at a competitive advantage or disadvantage as a result of the regulatory structure.

5.09 Another important implication of our recommended definition is that it focusses on the redeemability of shares or units rather than their continuous distribution to the public. Many persons think of the latter as the distinguishing feature of mutual funds, and it is clear that the great majority of mutual funds are in fact engaged in continuous distribution to the public of their shares or units. There are, however, several organizations commonly known as mutual funds which do not engage in continuous distribution but do provide the right of redemption. Guardian Growth Fund Limited ceased to sell shares to the public in April, 1968 after six years of continuous distribution. A G F Special Fund Limited effected a distribution of 12 million shares in 1968 and now issues only enough shares to equal the number redeemed. The latter procedure, with some variations, has since been followed by at least two other Canadian mutual funds, and it may become increasingly popular. In all these cases the mutual fund does not engage in continuous distribution, but its shareholders or unitholders have the right to require the redemption of their shares or units. We regard this right as the crucial fact and therefore believe that the non-distributing organizations should nonetheless be regarded as mutual funds.

5.10 It is also of importance that the proposed definition of itself imposes no restraints on the flexibility which we consider to be one of the most important features of the mutual fund as a form of organization. It encompasses a mutual fund that invests entirely in debt securities, or one which engages in highly speculative enterprises. It would not prevent the adaptation of the mutual fund concept to other situations. In this report we make recommendations for restrictions in specific aspects of operations, but all such recommendations are designed to preserve flexibility so far as possible consistent with protection of the investor.

5.11 At first impression, it might seem that our proposed definition would include as a mutual fund a type of organization that has been popular for some years in the United Kingdom, and has received limited acceptance in the United States, although to our knowledge it has been used only once in Canada. Organizations of this type are commonly referred to as dual purpose funds. While many variants exist, their objective is to provide for two classes of participants, those interested in long-term capital growth and those interested in income receipts. This is done through two classes of equity security referred to as capital and income shares or by equivalent terms. Detailed arrangements vary, but generally the capital and income shares are sold concurrently in a fixed-price underwriting.For a specified period, the income shares receive by way of dividend all of the organization's income, and the capital shares receive nothing. At the end of that specified period (usually over ten years after the initial distribution) the income shares are redeemed at a fixed price, and either the capital shares become redeemable at the holders option at net asset value, or the organization is wound up. In the latter case, the capital shares receive the accumulated capital in excess of any portion thereof required to redeem the income shares. The latter arrangement was adopted in the case of the Fulcrum Investment Company Limited, the only Canadian organization of this type; it is to be wound up in 1989.

5.12 A dual purpose fund would satisfy our proposed definition of a mutual fund only if, at the end of the specified initial period, a class of shares became redeemable at net asset value; and it would be a mutual fund only

after that date. We are aware that concern has been expressed as to the possible consequences of conflicts between the interests of the two classes of shareholders in the operations of such organizations during the initial period, and suggestions have been made to us that we should consider and make recommendations to avoid these consequences. Were we to do so, we would exceed the scope of our responsibilities; adequate consideration of this topic would require full analysis of the relationship between classes of shareholders of closed-end investment companies. Implementation of our recommendations would affect such organizations only from and after the date upon which they become mutual funds, if they are organized so that they do become mutual funds, and only one class of shares would remain outstanding after that date. We comment in paragraph 5.59 on the relevance to such organizations of our recommendations concerning equity capital structure.

5.13 For the reasons set out in this section, we recommend:

that the term "mutual fund" should be defined, subject to the exceptions recommended in the next section, to include any organization which issues, offers for issuance, or has outstanding instruments (whether called shares, units, or by another term) that entitle the holder to receive, on demand or within a specified period after demand, an amount computed by reference to the value of a proportionate interest in the assets of the issuing organization. If the redemption price is computed by reference to the value of a proportionate interest in a specified portfolio of assets such as a separate fund or trust account, that portfolio is treated under this definition as the issuing organization and therefore as an entity which is (again subject to the exceptions in the next section) a mutual fund.

Exceptions to the Proposed Definition of a Mutual Fund

5.14 The definition proposed in the preceding section would encompass many organizations of an essentially private nature. Most investment clubs would be caught by it, as would a variety of arrangements under which money from different sources is pooled in circumstances giving the beneficial owners

of the money the right to withdraw it at any time. While, as Chapter IV indicates, many of the problems with which this report is concerned are also present in the formation and operation of an investment club, it is the public nature of a mutual fund that makes these problems worthy of legislative attention. It would be pointless to apply the regulations we propose to organizations like investment clubs. We have therefore concluded that appropriate exceptions should be included in the definition of a mutual fund in order to exclude therefrom organizations which are in fact private arrangements.

5.15 It is easy to conclude that private arrangements ought not to be regulated as mutual funds, but considerably more difficult to decide what arrangements should be treated as private. In this connection, it is important that under the legislation of each Canadian province a prospectus must be filed with the securities administrator before a primary distribution of securities is made to the public in that province. This requirement would ordinarily encompass a public sale of mutual fund shares or units. We have concluded that even if an organization is a mutual fund within the definition proposed in the preceding section it should not be treated as such for regulatory purposes unless it has engaged or is engaging in a primary distribution to the public of its shares or units.

5.16 The provincial securities acts include a number of exemptions from the prospectus filing requirements so that sales may be made to institutional investors as part of a primary distribution to the public without compliance with the prospectus requirements. Such sales are nonetheless in the course of primary distribution, and we do not propose the adoption of similar exemptions in the definition of a mutual fund. An organization that would otherwise be subject to the regulations we propose should not be exempted therefrom solely because its shares or units are held only by institutional investors. It would be exempted if those investors did not constitute the public or if, under the recommendation made in the next paragraph, there were fifty or less of them.

5.17 The exemption of organizations which neither have engaged nor are engaging in a primary distribution to the public would not in all cases be adequate to exclude essentially private organizations from regulation as mutual funds. This is particularly true in light of the conclusion in the preceding paragraph that the ordinary exemptions from the prospectus filing requirement should not be incorporated into the definition of a mutual fund. Many distributions of an essentially private nature are considered to be public distributions under Canadian law. We have therefore concluded that subject to the overriding discretion of the appropriate administrator proposed in the following paragraph, an organization in which fifty persons or less have an interest should not be regulated as a mutual fund. This number should be sufficiently large to exclude any organization that is truly private; any attempt at its use as a device to evade the regulatory scheme could be frustrated through use of the powers described in the next paragraph.

5.18 The exceptions proposed above from the mutual fund definition could be inappropriate in some circumstances. For example, an organization newly created by a mutual fund management company for purposes of public distribution, might, for a period of time, have only a few participants. Another possibility is that several persons proposing to participate in one organization could effect their investment through a common intermediary so that they would be treated as a single participant. On the other hand, in unusual circumstances it is possible that a genuinely private investment club might have more than fifty participants. We have concluded that the appropriate administrator should have power to determine that a particular organization which satisfies the definition of a mutual fund either is a mutual fund although it technically fits within an exception from the definition, or is not a mutual fund despite the fact that no exception is technically applicable to it. The administrator should have authority to make a ruling that an organization is not a mutual fund conditional upon future compliance by that organization with specified conditions, and to make such rulings retroactive in effect.

5.19 For the reasons set out in this section, we recommend:

(1) that an organization which satisfies the definition of a mutual fund proposed in paragraph 5.13 should, subject to recommendation (2), be exempted from that definition for regulatory purposes if either of the following conditions is satisfied:

 (a) it has not engaged and is not engaging in the primary distribution to the public of its shares or units; or

 (b) its shares or units are held by fifty persons or less; and

(2) that the appropriate administrator should have power to determine that an organization which satisfies the definition of a mutual fund proposed in paragraph 5.13 either:

 (a) is a mutual fund notwithstanding that it falls within one or both of the exemptions proposed in recommendation (1); or

 (b) is not a mutual fund; a determination that an organization is not a mutual fund could be made subject to future compliance by the organization concerned with conditions specified by the administrator, and could be made retroactive in effect.

Application of Proposed Definition to Trust Companies

5.20 One of the principal services performed by Canadian trust companies is the management of money on behalf of others. A great many types of legal relationship exist between the trust companies and the persons whose money is managed. A trust company may receive money or other assets as trustee under a trust agreement; executor under a will; investment manager under a contract; custodian appointed by the court or pursuant to a statute; debtor under a guaranteed deposit certificate or similar document evidencing money borrowed; and in a variety of other capacities. We have considered each of these capacities in order to assess which might be encompassed within our proposed definition of a mutual fund.

5.21 Money managed by a trust company is divided into separate accounts or trusts. Many of these are set up for a specific client. For example, the assets of an estate are usually managed as a separate account or trust. Similarly, a large pension fund or the assets of a single wealthy investor held under investment management may be so managed. The trust companies have, however, found it uneconomic to deal with money in a separate account unless a comparatively large amount is involved. For this reason, Canadian trust companies rely heavily and increasingly on pooled accounts, in which money belonging to several or many clients is combined for management as a single portfolio. In its brief to us the Trust Companies Association of Canada explains the development of these pooled accounts, with particular reference to their use (where governing legislation permits) in connection with smaller estates and trusts; pension funds; other trusts and agencies. The brief continues as follows:

> The pooled funds also accommodate deferred profit sharing plans and separate pooled funds may exist for registered retirement savings plans, the units being, for example, an equity investment, while the trust company's guaranteed investment certificates may constitute the fixed income assets for a registered retirement savings plan. At the end of 1967 member companies of this Association administered $3,386,247,589.00 in trusteed pension plans and other employee benefit plans. Our member companies administered assets at that point in time amounting to over $220 million for registered retirement savings plans. Assets held by trust companies as custodians for mutual fund organizations amounted to over $45 million for personal retirement plans and to over $10 million for pension trusts of mutual fund organizations. Assets under administration for supplemental unemployment benefit plans came to about $34.4 million; for deferred profit sharing plans to about $27.7 million and for employees' profit sharing plans, savings and thrift plans to some $75.9 million.*

5.22 The statistics included in the above quotation by the Trust Companies Association of Canada confirm the importance of the role played by pooled accounts in the operations of trust companies. Such accounts provide a vehicle whereby the assets of a number of clients may be combined in a single investment portfolio, and they can be so arranged as to be of value in a variety of situations. This is largely because they confer on their participants privileges corresponding to those of a shareholder or unitholder in a mutual fund. A good example is provided by the "common trust fund", a particular type of

* The Trust Companies Association of Canada, Submission to the Canadian Committee on Mutual Funds and Investment Contracts: (Toronto, June, 1968): page 9.

pooled account permitted by the applicable regulations in Ontario and, with variations, in other provinces. In its brief the Trust Companies Association refers to the common trust funds as "designed to facilitate investment of monies in the care of the trust company and belonging to various estates and trusts, generally smaller ones".* It is apparent from reading the governing regulation** that the mechanics of operation of common trust funds are almost identical to those of mutual funds. Valuation dates and procedures, and admissions and withdrawals of participants on the basis of the valuations made, are provided for in the regulation itself or are required to be provided for in the plan upon which a common trust fund is based. The same similarity with the mechanics of operation of mutual funds holds true for pooled accounts generally, whether or not they are technically qualified as common trust funds.

5.23 In spite of their similarities to mutual funds, we have concluded that most pooled accounts, including common trust funds, neither are nor should be caught by our recommended definition of a mutual fund. They are ordinarily established by the trust company for purposes of convenience in the administration of money for which the trust company is responsible and accountable, as executor, trustee, administrator or in some other capacity. Rarely are participations in pooled accounts sold to the public; even in cases where the sale is to "the public", only in rare cases would the number of participants exceed fifty. We do not propose that an exemption from the definition of a mutual fund should be provided for pooled accounts, but most of them would be able to take advantage of the other exemptions we propose. This result seems to us appropriate.

5.24 There is at least one type of pooled account provided by trust companies which would be caught by our proposed definition of a mutual fund and would rarely, if ever, fall within an exemption from that definition. This is the investment fund offered for public participation. At least 20 Canadian trust companies sponsored such investment funds at the end of 1968.

* Ibid., p. 8.

** Revised Regulations of Ontario, 1960, Regulation 414, under The Loan and Trust Corporations Act, is a good example.

Some were very small, with total net assets as low as $200,000 or less. Others were large; the total net assets of the three investment funds sponsored by The Canada Trust Company was $66,082,000, and the corresponding figure for the four investment funds sponsored by The Royal Trust Company was $51,058,425. So far as the trust company's internal procedures are concerned, the investment fund offered for public participation is treated as a pooled account.

5.25 In our opinion, there is no relevant distinction for regulatory purposes between investment funds offered for public participation by trust companies and other trusteed mutual funds. The only distinction in law is that the former are organized under declarations of trust and the latter under agreements of trust, a distinction which we do not consider to constitute a difference of substance. Details of participants' rights differ from instance to instance, but the only substantive difference between the internal procedures usually followed with trust company investment funds and those usually followed with trusteed mutual funds is that in the former case the portfolio is valued and the price of units computed much less frequently, usually monthly and in a few cases as infrequently as quarterly. An investment fund offered for public participation by a trust company both does and should satisfy our proposed definition of a mutual fund, provided that it has in excess of fifty participants.

5.26 In its brief to us, and in a separate preliminary statement of policy, the Trust Companies Association advanced arguments to the effect that the investment funds offered for public participation by Canadian trust companies should not be treated as mutual funds. The principal emphasis of these documents is on the contention that trust companies should not be subjected in one aspect of their operations to regulations administered by securities administrators, and in their other activities to regulations administered by registrars of trust companies or equivalent officials. The concluding sentence of the brief states, "We strongly take the position that any regulation of these pooled funds which may be required is and should remain the responsibility of the special agencies of government developed to supervise the trust industry under trust company legislation." We consider this argument in Chapter XVI.

5.27 The preliminary statement of policy and the brief also make a separate argument from that referred to in the preceding paragraph. They contend that, regardless of whether the regulations are administered by the same person who is responsible for other legislation applicable to them, the trust company investment funds should not be subjected to regulations similar to those applied to mutual funds. We do not accept this contention. In view of the importance of our conclusion on this point, it seems desirable briefly to consider the arguments advanced by the Trust Companies Association in support of its position.

5.28 The first argument is that "a particular application of the pooled fund technique by trust companies, in one case out of many, should [not] be considered as placing trust company operations within a quite separate industry, that of the mutual fund industry". It is apparent to us that when regulations are passed to control a certain type of business activity, an organization which carries on that activity should not be permitted to avoid the regulations simply because for it the activity is only one among many. In addition, we think it an exaggeration to state that the application to trust company investment funds of regulations such as are applied to mutual funds amounts to the inclusion of trust companies within the mutual fund industry, particularly since we make no recommendation that the administration of those regulations as they apply to trust companies should be confided to any officials other than those traditionally responsible for trust company regulations.

5.29 The second argument advanced by the Trust Companies Association is that the existing regulation of the trust company industry is adequate to deal with any problems that may arise with the operation of trust company in-investment funds. This argument has caused us concern. A number of the problems considered in this report are dealt with by legislation and regulation presently applicable to trust companies. Custody and segregation of assets, for example, is an area canvassed in some detail by regulations governing trust companies. Regulations in Ontario* and corresponding provision in some other pro-

* Revised Regulations of Ontario, 1960, Regulation 414, under The Loan and Trust Companies Act, is a good example.

vinces prescribe procedures for the operation of common trust funds very similar to certain of the provisions proposed in this report for application to mutual funds. We have been cognizant of this fact, particularly since we are reluctant to add unnecessarily to the burden of regulation borne by any financial institution.

5.30 We have concluded that the fact that trust companies are presently subject to legislative and regulatory requirements which are adequate to deal with some of the problems considered in this report is not sufficient justification for a complete exemption of trust company investment funds from the requirements we propose. In principle, such funds should be treated as mutual funds. We do not, however, wish to see a double burden of regulations imposed, and in paragraphs 16.52 to 16.57, we discuss the extent to which trust company investment funds should be exempted from specific regulations applicable to mutual funds.

5.31 The third argument advanced by the Trust Companies Association is that trust company investment funds are operated so differently from traditional mutual funds that they should be treated differently, even accepting that they are technically the same. This contention relates principally to the sale of units in the investment fund, which is usually carried on only by the trust company's staff from its own office, with no sales charge being included in the price. Apart from the fact that there is nothing to prevent a change of policy on this point (units in the investment fund of at least one Canadian trust company are presently sold by a direct sales force, with a sales charge levied), we cannot see why differences in practices relating to only one or two aspects of operations should be determinative of the regulations applied to all aspects of operations. The fact is that regardless of the manner in which the distribution is made, units of trust company investment funds are offered and sold to the public.

5.32 For the reasons stated, we have concluded that investment funds offered for public participation by trust companies both are and should be caught by our recommended definition of mutual funds, although the exceptions from that definition may be applicable in a few cases.

5.33 There is one other type of pooled account sponsored by trust companies which might be caught by our recommended definition of a mutual fund. In paragraph 1.26 we briefly describe the development by trust companies of arrangements to facilitate investment of money in registered retirement savings plans in order to obtain the benefit of certain provisions of the Income Tax Act. Those provisions permit the postponement of tax on income until retirement, provided that the money concerned is invested in a plan duly registered in compliance with statutory requirements. When the provisions were added to the Income Tax Act in 1957 several of the larger trust companies organized pooled accounts for investment by persons desiring to avail themselves of these tax advantages. In many instances, the pooled accounts are operated separately from the trust company investment funds, which were in most cases organized at later dates. Interests in the registered retirement savings plans pooled accounts are offered to members of the public; their valuation is determined by reference to a proportionate interest in the fund. If they also provide holders with the right to receive the value of their interests on demand or within a specified period after demand, all of them with over fifty participants would be mutual funds within our proposed definition.

5.34 Section 79B(2) of the Income Tax Act specifies that no plan will be acceptable as a registered retirement savings plan if it provides for the payment of any benefit before maturity, except by way of a refund of premiums. This restriction is presumably designed to encourage long-term savings. To comply with it, documents evidencing participation in most of the registered retirement savings plans of trust companies specify that no payment to the planholder will be made prior to maturity, being the date fixed for the commencement of annuity payments under the plan. We understand, however, that these provisions are generally regarded as unenforceable and that most trust companies will accede to a request received from a planholder that the plan be amended to disburse his accumulated funds to him. In other words, notwithstanding the specific provisions of the plan the planholder may demand payment of his proportionate interest at any time. Income tax must be paid at a minimum rate of 15% on the amount so received by the planholder.

5.35 An argument could be made on the basis of the legal position described in the preceding paragraph that a participant in a pooled account sponsored by a trust company for registered retirement savings plans is in fact entitled to receive the value of his interest on demand at any time. We do not think that this argument should be accepted for purposes of our proposed definition. The planholder must arrange for a plan amendment and accept a tax disadvantage before receiving his interest in the account. In addition, it is usually assumed that he cannot demand only a portion of his interest; if the plan is to be amended to permit payment of any of the money standing to his credit in the account, all of the money will be affected by the amendment. For these reasons, we do not regard accounts maintained solely to service registered retirement savings plans as mutual funds within our recommended definition.

5.36 For the reasons set out in this section, we recommend:

(1) that an investment fund offered for public participation by a trust company should be regarded as a mutual fund unless it has fifty participants, or less;

(2) that accounts maintained by trust companies solely to service retirement savings plans registered as such under section 79B of the Income Tax Act (Canada), should not be regarded as mutual funds; and

(3) that whether other common trust funds or pooled accounts are mutual funds should be determined by application of our proposed definition.

Application of Proposed Definition to Life Insurance Companies

5.37 In paragraphs 1.24 and 1.25 we briefly review the background of certain amendments made in 1961 to the federal statutes and corresponding amendments made subsequently to most of the provincial statutes governing life insurance companies. These amendments were designed to permit the issuance of policies which provide for at least some benefits that are not guaranteed, but vary with the performance of a portfolio of investments. This is done through the creation by the issuing company of a segregated or separate fund and the

determination of some of the policy benefits by reference to the value of proportionate interests in that fund; it is generally assumed that the policy must also contain some guaranteed benefits. As indicated by the quotation in paragraph 5.41, the manner in which guaranteed and variable benefits are combined differs considerably among the policies issued by various companies. The segregated fund is exempted from some, but not all, of the investment restrictions to which the assets of a life insurance company are generally subject. For convenience, in this report we refer to any life insurance policy with benefits computed in whole or in part by reference to the value of an interest in a segregated fund as a variable policy or a variable insurance policy.

5.38 The amendments to Canadian statutes which permitted the issuance of variable policies provided life insurance companies with a very considerable degree of added flexibility. They have traditionally been restricted to fixed-dollar guaranteed policies. Because of the nature of the companies' liabilities under these policies, good business practice requires that they follow conservative investment practices; legislation imposes the same requirement. Largely for this reason, life insurance companies tend to invest heavily in bonds, debentures and other debt instruments rather than in equities. As of December 31, 1967, the latest date at which information was available at the time of writing, only slightly less than 5% of the assets of Canadian life insurance companies were invested in equities, compared with approximately 89% for mutual funds. This investment policy has forced the life insurance industry to maintain guaranteed rates of return under life insurance policies at comparatively low levels. In the rising market which has prevailed in Canada for the last few years life insurance companies have earned higher rates of return on their reserves than those promised under the policies. A considerable portion of the excess has been distributed to policy holders, but their overall rate of return has not, on average, equalled that of mutual fund participants.

5.39 The factors described in the preceding paragraph created interest on the part of some policyholders in variable policies. From the viewpoint of the life insurance companies the desire to satisfy this interest was accentuated by their wish to service not only the need of Canadians for protection - for dollars payable in the event of death - but also their need for savings vehicles. The increasing desire of Canadians to invest their savings dollars in equities was and is of considerable concern to life insurance companies. It was the manifestation of this desire with respect to group policies and pension funds, noted in paragraph 1.24, that provided the immediate motivation for the life insurance companies to request passage of the statutory amendments permitting variable policies. In practice, the use of the resultant powers has not been restricted to group policies and pension funds; a number of companies offer variable policies for individuals.

5.40 The development of individual variable policies has almost certainly been hastened because Canadian life insurance companies are prohibited from the acquisition of subsidiary companies. This is commented on further in paragraph 16.39 where we conclude that they should be allowed to acquire mutual fund management and distribution companies as subsidiaries. Their present inability to do so has forced them to rely heavily on variable policies in order to satisfy the desire of policyholders for equity-linked investments. At the end of 1967 some dozen Canadian life insurance companies were issuing variable policies on an individual basis, although this business was not nearly as large in volume as the group variable policies were. All available indications point to the conclusion that variable policies, both group and individual, will form an increasingly important aspect of life insurance company operations.

5.41 While the concept of the segregated fund is simple, it can be used in a variety of ways in life insurance policies. The provisions of some variable policies spelling out the relationship between fixed-dollar protection (which is provided by every variable policy known to us) and variable protection are very complicated. The following extract from the brief to us prepared by the Canadian Life Insurance Association indicates the range of variable

policies available from Canadian companies:

> Eight companies issue contracts in which the equity investment is integrated with regular life, endowment or term insurance. One company issues a participating whole life contract with the same death benefit and the same premium as its corresponding fixed-dollar plan. It differs from the fixed-dollar plan in that half the policy reserve, after the first policy year, is invested in a variable fund and the difference between the performance of that fund and the interest earnings on the company's general fund is reflected in a yearly adjustment (positive or negative) to additional insurance purchased by the regular fixed-dollar dividend. This contract contains the same guaranteed cash values as the fixed-dollar plan, subject only to the differential in the value of the dividend additions at the time of surrender. Another company offers plans with 25%, 50% or 75% of the policy reserve directed into its variable fund. A third company issues 10 to 30 year endowment contracts in which the investment portion of each premium is used to purchase units in its equity fund, but minimum cash values are guaranteed throughout. The other five companies offer insurance plans maturing at age 65 or 70, with cash values wholly dependent on investment performance. The portion of the premium invested in the fund is specified in each policy and one company will permit the insurance coverage to be maintained even if the investment portion of the premium is discontinued.*

5.42 The variety of techniques described in the quotation by no means exhaust the uses or potential uses of segregated funds in variable policies. Developments in the United States, England and Holland, among other countries, foreshadow even more sophisticated uses of the new device in Canada. We think experimentation with a new product is highly desirable, and that the flexibility which the range of variable policies evidences is a valuable feature of the new legislation. On the other hand, these points contribute to the difficulty involved in any attempt at a clear explanation of variable policies to potential purchasers, and the very novelty of some of the developments confirms that existing life insurance company regulation was not designed to deal with them.

5.43 Variable policies are probably the most important new technique adopted by the Canadian life insurance industry in the past decade. They provide an important addition to the range of policies made available to the public and can be of great benefit to the policyholder. It must, however, be appreciated that they constitute a major departure from traditional concepts of life insurance. The life insurance industry in Canada is one of the most

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* The Canadian Life Insurance Association, Submission to the Canadian Committee on Mutual Funds and Investment Contracts; (Toronto, June 1968): pages 31-32.

successful in the world.* Its reputation and success are founded on an excellent solvency record and capable marketing and servicing of fixed-dollar contracts. We reject an argument which has been made to us, that life insurance companies should not be permitted to issue variable policies at all because the reputation for safety which they have so successfully created is inconsistent with the issuance of policies carrying benefits that could theoretically decline to zero. Despite our rejection, this argument emphasizes the differences between variable and traditional policies and, inferentially, the necessity to ensure that such differences are adequately explained to potential purchasers of variable policies who might not otherwise appreciate their implications.

5.44 Two related but distinct questions must be considered with respect to variable policies. The first is whether they raise problems that are not adequately resolved by existing legislation applicable to the life insurance industry. The second is whether the segregated funds upon which their variable elements are based should be regarded as mutual funds for regulatory purposes. We answer the first question strongly in the affirmative. For narrow technical reasons we answer the second question in the negative, although this only means that we think special regulations should be enacted for application to segregated funds and variable policies. The reasons for these conclusions are indicated in the following paragraphs.

5.45 We have concluded that variable policies are a desirable development, and that their issuance by life insurance companies should continue to be permitted. We believe, however, that they raise very considerable difficulties from a regulatory standpoint. The emphasis traditionally placed on reserve requirements by life insurance regulation is inappropriate to segregated funds, since the benefits for which they constitute the reserves are not guar-

* The following quotation is from the Canadian Life Insurance Facts Booklet for 1968: (chart and table omitted).

Canadians rank fourth in life insurance ownership in the world. The citizens of the United States, Japan and Britain own more life insurance. On a per capita basis, ownership of life insurance by Canadians rank second, after that of the people of the United States. Canadians own an average of $4,360; Americans, $5,400. Relative to national income, Canadians own more life insurance than the people of any other country.

anteed benefits. On the other hand, the operation of such funds does raise many of the problems considered in this report, problems not ordinarily involved in the business of a life insurance company; this is particularly true of segregated funds used as the basis for determination of benefits under individual variable policies. In addition, segregated funds are directly competitive with mutual funds for savings dollars; this, again, is particularly true of those established for individual variable policies. If they are subject to different legislative schemes one may well be given a competitive advantage over the other. For all these reasons, we have concluded that individual variable policies and the segregated funds upon which they are based should be subject to regulations similar to those applied to mutual funds. In paragraphs 16.44 to 16.49 we propose a definition of individual variable policies designed to include all variable policies except group variable policies sold after detailed negotiations. The distinction between individual and group variable policies has been recognized by the Superintendents of Insurance in the provinces and the federal government of Canada, who have prepared interim rules governing individual variable policies pending publication of this report.

5.46 The second question referred to in paragraph 5.44 is whether segregated funds are mutual funds within our proposed definition of that term. That definition is both narrow and precise. The terms of variable policies differ greatly, and some do while others do not satisfy the technical requirements of the definition. Certainly their emphasis is not on ready redeemability, whether or not they provide a cash surrender value based on the value of an interest in the segregated fund; the primary emphasis is on long-term savings. We have concluded that these funds should be regulated under provisions designed specifically for application to them, rather than under legislation governing mutual funds. For that reason, segregated funds used as the basis for individual variable policies should not be regarded as mutual funds, within the narrow definition of that term, but should be subject to similar requirements in legislation which takes account of their structure and method of operation. This is discussed further in paragraphs 16.34 to 16.40.

5.47 For the reasons set out in this section, we recommend:

(1) that segregated or separate funds of life insurance companies should not be regarded as mutual funds within our proposed definition; and

(2) that segregated or separate funds used as the basis for determination of benefits payable under individual variable policies should be regulated by provisions substantially similar to those recommended in this report for application to mutual funds; paragraph 16.51 contains detailed recommendations on the nature of the regulations that should be applicable to segregated funds, and the definition of individual variable policies.

Application of Proposed Definition to Other Financial Institutions

5.48 The success of mutual funds has attracted other financial institutions in addition to the life insurance companies and trust companies. These other institutions have not attempted to create their own variations of the mutual fund share or unit for public sale. Instead, they have either made arrangements with the distribution company associated with an existing mutual fund to participate in the distribution of the shares or units of that mutual fund, or have organized a mutual fund so as to obtain the benefit of management or investment advisory fees as well as of sales charges. In a few cases, financial institutions entering the mutual fund field have purchased the shares of a management company or have arranged to acquire a management company's rights under an existing management contract. Whatever procedure is followed, the shares or units sold to the public are clearly those of a mutual fund.

5.49 A relationship which has aroused particular controversy is that between certain chartered banks and mutual funds. At the time of writing, three chartered banks have developed such relationships, although they differ considerably in detail; they are described in paragraphs 16.07 to 16.28
No problem of definition arises in these cases, for the shares or units sold are issued by organizations which clearly are mutual funds; one is a trust company investment fund sponsored by a trust company associated with the chartered bank. In Chapter XVI, we discuss the nature of these relationships and certain

problems involved in the application to chartered banks and their associated mutual funds of the regulatory scheme we propose.

5.50 In principle, we do not object to the distribution by financial institutions of mutual fund shares or units as one part of the array of services offered their clients. So long as the regulatory structure is uniformly applied to ensure general compliance with prescribed standards of investor protection, we think that the development of a variety of outlets for mutual fund shares or units can only be beneficial. Better service will be provided by financial institutions to their clients, and the quality of competition within the mutual fund industry will be improved commensurately.

5.51 The fact that financial institutions other than trust companies and life insurance companies have not developed new types of instruments competitive with mutual fund shares or units does not mean that such instruments will not be developed in the future. For example, it is possible that the chartered banks might become more directly involved in investment management than is presently the case, although the consensus of those who have commented on the point is that such involvement is not permitted by the Bank Act. Should such a development occur, the vehicle used might or might not satisfy the technical definition of a mutual fund proposed in this chapter, but the considerations which lead to the use of that definition could be applied to determine whether the new type of instrument is one for which the regulatory scheme we propose would be appropriate. The analysis would correspond to our discussion of variable policies in the preceding section. The same type of analysis would be appropriate for instruments issued by other financial institutions.

5.52 It is impossible to predict future developments of financial institutions with any certainty. It would be an impossible task for us to list all the types of instruments that might be issued by financial institutions and to determine which of them should be regulated in the way that mutual funds are regulated. We are satisfied that our proposed definition of a mutual fund is adequate to deal with instruments presently being issued, and

to provide guidelines for the type of analysis suggested concerning newly created instruments. If Parliament and the Legislatures of the Provinces accept the recommendations made in this report, they should continue to be alert for the development of new types of instruments which require the application of controls similar to those proposed in this report.

5.53 For the reasons set out in this section, we recommend:

that a continuing review should be maintained of newly created types of financial instruments, and that all new financial instruments should be analyzed to determine whether their issuers ought to be regulated as mutual funds, and whether the application of regulations similar to those recommended in this report would be appropriate.

Capital Structure of Mutual Funds: Equity Securities

5.54 In paragraph 5.03 we note that most recommendations in this report apply to all mutual funds regardless of whether they are organized as companies, as trusts, or otherwise. That is true with respect to the conclusions set out in this section, but the principal impact of those conclusions will be on the laws applicable to incorporated mutual funds. Mutual funds which, for income tax considerations or other reasons, have been organized as companies must conform with legislative requirements not well adapted to the mutual fund. This has resulted in the forced acceptance of certain restrictions that we regard as inappropriate for mutual funds. No such restrictions have been forced, by reason only of their form of organization, on mutual funds organized as trusts, because the general legislation applicable to trusts is less detailed than that applicable to companies. Nor would a mutual fund organized as a partnership be subject to such restrictions.

5.55 The most important of the corporations act restrictions referred to in the preceding paragraph are those which affect the equity capital structure of companies. That term is here used in the wide sense to include the nature of the financial claim against the company represented by its equity securities. In this section we consider these restrictions, and arrive at a number of specific conclusions. Because the corporations act restrictions

that are referred to in this section are technical in nature and not of general interest, the references in this discussion are comparatively brief. The problems considered are well known to lawyers and accountants concerned with mutual funds, and detailed discussion of the existing position seems unnecessary.

5.56 To appreciate the problems that have arisen in the application to mutual funds of the corporations acts it is necessary to consider the nature of the equity structure of the company which carries on a commercial business or even of a closed-end investment company. Such companies may have more than one class of shares called common shares; they often have several classes of preferred shares. All of these classes differ from one another in various respects, but the most important differences are those which relate to the nature of the financial claims against the company represented by the shares; to most investors even voting rights are of less importance. The claim against the company represented by a share is determined by the general law and by the share conditions of that class considered in relation to those of other classes. A share may or may not carry a right of participation in earnings; if such a right is provided, it may or may not be subject to prior satisfaction of a claim held by another class of shares. The possible variations in rights and combinations of rights are endless, and it is apparent that to allow unlimited flexibility in the determination of the rights could result in abuses. For that reason, the corporations acts provide restrictions to require compliance with certain basic rules. It is those restrictions with which we are here concerned. If their application to incorporated mutual funds is necessary, similar rules should presumably be applied to trusteed mutual funds; otherwise, the rules should be made inapplicable to incorporated mutual funds.

5.57 As a vehicle for the pooling of money in a single investment portfolio, the mutual fund is fundamentally different from the ordinary company which issues classes of securities with different financial claims. It is crucial to the effective operation of a mutual fund that the value of the interest held by each participant should be capable of precise determination. Unfairness

for existing participants or new purchasers will result if the price determined is too high or too low. The existence of two classes of equity participation, with different financial rights against the mutual fund, would at the very least make the task of price determination far more complicated, and might well make it impossible. In addition, the existence of two or more classes of equity participation would be inconsistent with our approach to the mutual fund as a vehicle for the pooling of money in a portfolio. In our opinion, the only questions relevant in the valuation of a participant's interest should be the time and amount of his contributions and withdrawals, the time and amount of contributions and withdrawals made by others, and the current net asset value of the portfolio. Consideration of these factors will result in equal treatment of participants; consideration of other factors in the determination of the value of shares or units would deny such equal treatment.

5.58 For the reasons indicated in the preceding paragraph we have concluded that equal treatment of mutual fund participants in the determination of the value of their shares or units should be required by statute. As a necessary corollary, we have concluded that the shares or units issued by a mutual fund should be uniform in the nature of their financial claim against it, although they might differ in other respects; the most important areas of potential difference are noted in paragraph 5.62. The conclusion that shares or units of a mutual fund should represent equal financial claims seems to us one that would be difficult to dispute; its implementation through legislation would have virtually no effect on existing practices either in the context of incorporated or of trusteed mutual funds. The limited implications of this conclusion can be appreciated from a few examples. We discuss below the two-class share structure which characterizes most incorporated Canadian mutual funds. That structure is not inconsistent with our conclusion as to equality of financial claims, since the value of the two classes is ordinarily the same although one carries the right of redemption and the other does not; they may also differ with respect to voting rights. We quarrel with the reasons that underly the requirement for two classes of shares, and express certain conclusions below concerning those reasons, but we see nothing in them inconsistent with equality of financial participation. Our conclusion as to equal

treatment of participants would also have no effect on the issuance of debt securities by the mutual fund; we discuss in paragraphs 5.73 to 5.77 whether restrictions on debt securities should be imposed for other reasons.

5.59 In paragraphs 5.11 and 5.12 we discuss the dual-purpose funds, organizations that issue separate classes of equity securities designed to appeal to those interested in capital growth and to those interested in income receipts. For the reasons there indicated such organizations are not ordinarily mutual funds during the initial period while two classes of shares are outstanding, and our conclusion with respect to equality of participation would therefore not apply to them. That conclusion would be inconsistent with the issuance by such an organization of mutual fund shares during the period when two classes of securities are outstanding; for example, it would not be permissible to have outstanding at the same time capital shares redeemable on demand by the holder at net asset value and income shares entitled to all the income of the organization. In our opinion, an organization with outstanding classes of income and capital shares one or both of which were mutual fund shares would, apart from the problems of fairness it would raise, be highly undesirable from a practical and business standpoint. We are aware of no instance in which it has been attempted; the organizations described in paragraphs 5.11 and 5.12 have shares which become redeemable on demand by the holder, if at all, only after other classes of shares have been eliminated. We therefore conclude that in an organization in which the holders of two or more outstanding classes of equity shares have different financial claims neither class should be permitted the privilege of redeemability at the holder's option.

5.60 The only important substantive effect of our conclusion would be that it would prohibit privileges for the acquisition of mutual fund shares or units at a price below the current value of such shares or units. Many businesses issue warrants or options which permit the holder to acquire shares at a fixed price, or at a price determined by formula, at any time within a specified period regardless of the prevailing market price. In our opinion, such privileges are completely inappropriate in the context of mutual funds. They

are not necessary or desirable as an incentive to management, for management has an adequate source of entrepreneurial reward in the management and distribution companies. In cases where the net asset value is in excess of the option price, the very existence of options or warrants complicates the determination of valuation for issuance and redemption of shares or units, and may make fair valuation impossible; their exercise could substantially dilute the equity position of the other participants. We believe that such arrangements should be prohibited.

5.61 While a number of Canadian mutual funds have authority under their letters patent or other organizational instruments to issue warrants or options for the acquisition of their shares or units, to our knowledge only one has such instruments outstanding. Canadian Gas and Energy Fund Ltd. was originally organized as a closed-end investment company, and issued warrants for the purchase of its shares prior to its conversion into a mutual fund. At the time it became a mutual fund, discussions were held with securities administrators and arrangements made with respect to the warrants. Without determining that such arrangements resolve the problems, we have concluded that it would be unfair to the holders of the warrants to require that they be abolished at this time. Previously issued options or warrants should therefore not be affected by legislation to implement this report.

5.62 Because corporate law in Canada ordinarily restricts the characteristic of redeemability to preferred shares, most incorporated Canadian mutual funds have two classes of equity shares; the mutual fund shares sold to the public are, technically, preferred shares and there is an underlying class of common shares which are of equal value but are not redeemable. The only important exceptions to this statement are a few mutual funds incorporated under the Canada Corporations Act subsequent to amendments to that Act made in 1965. Doubt is presently being cast on the necessity for the prohibition against redemption or purchase by a company of its own common shares in company law generally*; we have concluded that it is clearly inappropriate in

* Perhaps the best example is certain provisions of the draft of the Business Corporations Act 1968, introduced before the legislature of Ontario on May 17, 1968 as Bill 125. Section 39 would permit companies to purchase their own common shares, subject to appropriate restrictions.

the context of mutual funds. Incorporated mutual funds, like all other mutual funds, should be permitted to have a single class of shares or units. This should not be a requirement; subject to compliance with the rule as to equality of financial participation and the other relevant conclusions in this report, more than one class of shares or units should be permitted. For example, voting rights could differ between classes on matters other than those as to which voting rights are required under the conclusions in paragraphs 6.45 to 6.59. Similarly, one class could be redeemable on demand by the holder while another lacked that right.

5.63 A consequence of the existing requirement under corporations acts that the mutual fund shares issued by incorporated mutual funds must be preferred shares is a further requirement that they have a par value, for redeemable preferred shares traditionally must have a par value. In practice the par values used are very low, because this minimizes the fees that must be paid for the issuance of letters patent or supplementary letters patent and because the excess of purchase price over par value is available as a source of funds for redemption payments under the rules referred to in paragraph 5.67; as indicated in paragraph 5.68, such excess may also be available for dividend payments. In view of the fact that neither issue nor redemption price of mutual fund shares has any reference to par value, we can see no necessity for this requirement. We have therefore concluded that mutual fund shares should not be required to have a par value. This conclusion assumes the implementation of our conclusions in paragraphs 5.67 and 5.69 with respect to sources of funds for redemptions and dividend payments. It also assumes that appropriate adjustments will be made so that higher fees will not be charged for letters patent and supplementary letters patent as a result of the implementation of our conclusions.

5.64 Another consequence of the application of traditional corporate law requirements to incorporated mutual funds is that they are not permitted to re-issue shares which have been redeemed. The theory underlying this restriction is that such shares are cancelled, so cannot be re-issued; new shares must instead be created. This requirement occasions considerable

difficulty from an accounting standpoint, and necessitates regular applications for supplementary letters patent creating new authorized shares. The latter necessity involves unnecessary administrative efforts and fees. We have concluded that all mutual funds, including incorporated mutual funds, should be permitted to re-issue mutual fund shares or units following their redemption. Implementation of this conclusion, accompanied by adjustments in the fee structure, will avoid financial penalties to incorporated mutual funds the shares of which are without par value.

5.65 Implementation of the proposals in this section will require extensive adjustment in applicable corporations acts. The relevant amendments should not impose the changes as requirements, but should permit mutual funds to take advantage of them. This should extend to existing mutual funds through special provisions enabling supplementary letters patent to be readily obtained.

5.66 For the reasons set out in this section, we recommend:

(1) that the equity securities of a mutual fund should be equal in the value of their claims against its assets;

(2) that recommendation (1) should prohibit the issuance of warrants, options, or other rights to acquire mutual fund shares or units at a price other than the price computed, in accordance with recommendations in Chapter XIII, by reference to the value of a proportionate interest in the assets of the mutual fund at the time of purchase; provided that any previously outstanding warrants, options or other rights should not be invalidated;

(3) that mutual fund shares or units should be permitted to be without nominal or par value, provided that appropriate amendments should be made in the fee structures for letters patent or supplementary letters patent so that implementation of this recommendation would not substantially increase the fees required to be paid for letters patent or supplementary letters patent issued to incorporated mutual funds;

(4) that mutual funds should be permitted to re-issue shares or units which have been redeemed;

(5) that the preceding recommendations, particularly recommendation (1), should not be considered to be inconsistent with the issuance by a mutual fund of two or more classes of shares or units provided that they comply with recommendation (1) and that any other differences between them are consistent with conclusions reached in this report; permitted differences should include the issuance of a class of shares or units not subject to redemption on demand by the holder or with voting rights that differ between classes except on matters as to which equality of voting rights is required under recommendations made in paragraph 6.59; and

(6) that corporations acts should be amended to permit, but not to require mutual funds to take advantage of the preceding recommendations, except that recommendations (1) and (2) should be of general application and that the amendments should provide a procedure whereby existing incorporated mutual funds may readily take advantage of them.

Restrictions on Sources of Money for Dividends and Redemption

5.67 Most of the conclusions in the preceding section, apart from the basic decision that mutual funds should not have outstanding shares or units with different financial claims, concern changes in existing corporations acts which are desirable but are not necessary for investor protection. That is why we propose that they be implemented on a permissive rather than a compulsory basis. Other provisions of corporations acts cause us greater concern, for they limit the sources of money that may be used for redemption of shares. The primary purpose of such restrictions is to protect creditors and holders of senior classes of equity securities from unauthorized reductions of equity capital. To do this, redemptions are prohibited unless effected out of income or surplus. In view of the restrictions that we propose on the extent to which mutual funds should be permitted to incur debt, as described in paragraphs 5.75 and 5.76 and in Chapter XII, we do not consider such restrictions to be

necessary for the protection of mutual fund creditors. In view of our conclusion as to equality of equity participation such restrictions are also unnecessary for the protection of holders of senior classes of equity securities. We are aware of no other reason that would necessitate the application of such restrictions to mutual funds. To avoid the possibility that the restrictions might prevent a solvent mutual fund from satisfying requests for redemption, the Canada Corporations Act and the corporations acts of a few provinces have already been amended to permit redemptions from capital. We have concluded that no mutual fund, incorporated or unincorporated, should be restricted as to the sources of the money it may use to effect redemption.

5.68 Closely related to the corporations act restrictions on the sources of money that may be used to effect redemptions are similar restrictions on the sources of money that may be used for dividend payments. These restrictions have occasioned considerable difficulty for incorporated mutual funds; for example, there is a lack of consensus as to whether dividends may be paid from the amount received in excess of par value on the sale of shares in an incorporated mutual fund. If such dividends are permitted, problems arise from the fact that a portion of the amount paid by each incoming shareholder becomes available for distribution to all shareholders; complicated accounting procedures are often followed to minimize resultant unfairness. The arguments on the merits of these restrictions are well summarized by the following quotation from a letter prepared by the Government Relations and Legal Affairs Committee of the Montreal Society of Financial Analysts in response to our request for comment on a report prepared by one of our consultants:

> The author [of the report referred to above] is of the opinion that dividends should not be paid out of surplus. He cannot resolve the dilution of distributable earnings on the selling of additional shares. We cannot resolve it either, but it does seem that new shareholders who buy an historical pay-out policy should not be precluded from that demonstrated pay-out policy by the mere fact of purchasing units in the fund. The overall return is the important item to the shareholder. If he wants a small cash pay-out and if that must temporarily come out of his recent contributions to the fund in the form of paid-in surplus, there can be no serious objection as long as it is fully disclosed in an understandable way. Accordingly, we have doubts about the author's adamant position that dividends cannot be paid out of paid-in surplus.

In fairness to our consultant, it should be stated that his position in discussions with us has been far from adamant; he recognizes the merits of the arguments in the above quotation.

5.69 The principal purpose of the restrictions on sources of money for dividend payments, like the corresponding restrictions on sources of money for redemption, is the protection of creditors. As indicated in paragraph 5.67, we have concluded that our proposed restrictions on the extent and nature of debt securities that should be permissible for mutual funds would negate the need for this type of protection for creditors. We therefore also conclude that the position taken in the above quotation is the correct one, and that no mutual fund, incorporated or unincorporated, should be restricted as to the sources of the money it may use for dividend payments.

5.70 The conclusions set out in this section should be implemented on a mandatory rather than a permissive basis. We can conceive of no reason why it would be desirable for a mutual fund to be subjected to restrictions on sources of money for redemptions and dividend payments; nor can we conceive of any problem that would result from statutory repeal of these restrictions with respect to all incorporated mutual funds. In addition, it is possible that problems might result from the continued existence of the restrictions. We have therefore concluded that such restrictions should be repealed not only for mutual funds incorporated in the future but for those currently in existence.

5.71 The conclusions reached in this section have considerable relevance to the form of accounting presentation used by mutual funds. They would permit, in our opinion, substantially clearer presentation of financial information. This is fully discussed in Chapter XV.

5.72 For the reasons set out in this section, we recommend:

> that mutual funds should be subject to no statutory restrictions on the sources of the money they may use for redemptions of shares or for dividends, and that corporations acts should be appropriately amended.

Capital Structure of Mutual Funds: Borrowing

5.73 The extent to which mutual funds should be permitted to borrow is a controversial question which is discussed at length in Chapter XII, where we make detailed proposals to provide flexibility in this aspect of industry operations. In this section we are concerned only to a limited extent with the quantum of borrowing by mutual funds; our principal concern is with the procedures to be followed when borrowing is actually effected. Little guidance on either question can be derived from present practices in Canada, for very few Canadian mutual funds presently are permitted to borrow except on a very limited basis. The only borrowing right most possess is that they may borrow money to effect redemptions in emergencies, provided that the amount borrowed does not exceed a specified percentage of total net assets; the percentage, in most cases, is about 5%.

5.74 In paragraph 12.42 we propose that borrowing by mutual funds should be restricted to loans which they are permitted to discharge at any time without notice or bonus. This restriction could almost certainly make it impractical for a mutual fund to borrow money from the public, but we have concluded that public borrowings should be specifically prohibited even if they could be effected in compliance with the conclusions reached in Chapter XII. We do not believe that portfolio managers should be put in a position of responsibility to public debt holders as well as public equity holders. The reasons are well described in a memorandum prepared by the Securities and Exchange Commission at the time of passage of the Investment Company Act of 1940, which also dealt with the argument that similar problems can exist with any public company and there is no reason to single out investment companies for special treatment. The following quotation is from that memorandum:

> It is true that the potentialities of a conflict of interest may exist in the case of any corporation between the senior securities which can generally look forward to only a fixed and limited return and hence tend to favour a conservative policy and the equity securities which are entitled to all of the surplus profits and hence tend to favour a more speculative policy. But, this conflict rarely comes to bear upon the actual activities of industrial companies because the activities of such companies are definite, circumscribed, well established, and generally acceptable to all types of security holders. Compared to the possible variation of activities of investment companies the distinction between running a specific industrial enterprise in a conservative

> or a speculative fashion is relatively minor. While any corporation may from time to time oscillate - within a narrow orbit - between a somewhat more or less conservative policy in the conduct of its established line of activity, it cannot, like an investment company at the present time [i.e. before the 1940 Act], within a few days entirely change the character of its activities, for example, from the use of its assets in diversified investment to speculative trading or to the financing of a single hazardous special interest. In short, while this conflict is possibly latent in the case of other companies, the conflict in the case of investment companies is continuous and acute.*

5.75 It might be said that the problems described in the above quotation would apply equally where money is borrowed from an institutional lender. We have concluded that the right of prepayment without notice or bonus would provide the mutual fund with adequate protection against any such conflict of interests. The borrowing would be effected for leverage only, and if the lender demanded that a more conservative investment policy be followed the borrower would almost certainly repay the loan. On the other hand, the public debt holder would not be in a position to make such a demand or to protect himself against the consequences of changes in investment policy. Institutional loans capable of prepayment by the borrower are, then, the only category of loans to a mutual fund which would not occasion conflicts of interests that might be harmful.

5.76 In order to ensure that debt instruments of mutual funds are not sold publicly, we have concluded that mutual funds should be permitted to borrow only from institutional lenders, including banks and other organizations duly licensed to engage in the lending of money. Such lenders are well able to fend for themselves and do not require disclosure type protections. This leaves open the question whether borrowing should be permitted from a broker, either through the use of a margin account or by direct loan. We have concluded that, with the necessary exception of borrowings of securities to deliver against short sales, such borrowings should not be permitted. Brokers would rarely be relied on for loans in any event, since the interest rate available from banks is almost invariably lower than that available from brokers. The small

* [Memorandum entitled "Provisions of the Proposed Bill Relating to Capital Structure" reproduced in Part 2 of Hearings Before a Subcommittee of the Committee on Banking and Currency, United States Senate, third session, Seventy-Sixth Congress, on S. 3580, page 1025 at pages 1032-1033.]

additional flexibility provided by the availability of the power to borrow from brokers would not compensate for the dangers that would be inherent in such a procedure. Many mutual funds have brokerage firms associated with them, and a loan to a mutual fund by an associated brokerage firm would involve the potentiality of serious abuse.

5.77 One exception should be made from the restriction proposed in the preceding paragraph. In paragraph 12.51 we conclude that all mutual funds should be allowed to borrow money to effect redemptions in emergency cases, provided that the amount so borrowed is not in excess of 5% of the total net assets of the mutual fund. When the mutual fund borrows pursuant to this power, speed may be of the essence and it might be convenient to borrow other than from an institutional lender. We have therefore concluded that such loans should not be restricted to institutional lenders, although they should not be made by a public distribution of debt instruments.

5.78 For the reasons set out in this section, we recommend:

(1) that mutual funds should be prohibited from borrowing, except to the extent permitted under recommendations made in Chapter XII;

(2) that mutual funds should not be permitted to effect borrowings by public distribution of debt instruments;

(3) that, subject to recommendation (4), borrowings effected by mutual funds in accordance with the recommendations in Chapter XII should be restricted to institutional lenders, including banks and other organizations duly licensed to engage in the lending of money, but not including brokers, except that securities for delivery against short sales may be borrowed from brokers; and

(4) that borrowings made to effect redemptions in emergencies pursuant to paragraph 12.60, recommendation (3) should not be subject to recommendation (3) but should be subject to recommendation (2).

CHAPTER VI

THE RELATIONSHIP BETWEEN MUTUAL FUND INVESTORS AND MANAGEMENT

6.01 During the course of our work we have been struck by the lack of consensus within the mutual fund industry, and among regulators and commentators, as to the nature of the relationship between the mutual fund, its investors, and its management company. The two prevalent philosophies are alluded to in paragraph 4.12. On the one hand, many consider the mutual fund to be simply the method by which the management company provides the service of investment management for those prepared to entrust their money to it. On the other hand, it is often regarded as an enterprise, separate from the management company, that consists of an investment portfolio operated for the benefit of its participants; those who accept this philosophy acknowledge that the management company has the right to provide investment advice and administrative services, but emphasize that the right is only contractual and that if it renders poor service the management company can be dismissed and replaced with a successor selected by the mutual fund. To the extent that this is not true of trusteed mutual funds, including trust company investment funds, they feel that regulatory requirements should make it true. Under the first philosophy, then, the person who invests in a mutual fund through purchase of its shares or units is considered to purchase the right to have his money managed by the management company; under the second, he is considered to acquire an interest in a separate enterprise which has a terminable contract with the management company.

6.02 The Canadian mutual fund industry includes mutual funds that seem to exemplify each of the two philosophies as to relationships between mutual funds and their management companies. Some mutual funds have been organized by brokerage firms solely to cater to clients who wish to have their money managed by the firm on a discretionary account basis, but are unable to invest enough to permit its economic administration as a separate account. These provide a good example of the philosophy that the mutual fund is a means whereby the management company sells the service of investment management. Those concerned would probably be surprised at any suggestion that the mutual fund could dismiss the brokerage firm as investment manager and replace it with another. Trust company investment funds are another category of mutual funds that reflect the same philosophy.

6.03 The mutual fund as a separate entity, able to negotiate with or to dismiss the management company, is well exemplified by Commonwealth International Corporation Limited and Commonwealth International Leverage Fund Ltd., which are discussed in the next section. These are incorporated mutual funds under common management. At the time of the events considered in the next section (to a considerable extent, the following description continues to be true of them at the time of writing), they were organized in a manner which reflected a philosophy of a mutual fund's role almost directly opposite to that represented by the trust company investment funds. They had a common board of directors of which a majority of the members were independent of the management company. These directors considered the mutual funds to be operating business enterprises set up in a manner similar to a commercial company. To them, the contract with the management company did not simply represent the terms upon which the management company was prepared to accept money for investment management; rather, it was a contract for advice on investments, to be negotiated with the management company and to be replaced by a contract with another company in the event the advice proved unsatisfactory. They also felt an obligation to review all advice submitted and to reject any with which they disagreed.

6.04 The two philosophies of relationships between the mutual fund and its management company are logically irreconcilable, and it is important to consider their relative merits in the formulation of a regulatory scheme. The first of the two philosophies seems to us to accord more closely with the realities of the situation. We view the mutual fund investor as a person who wishes to delegate the management of his money, and we think that those who consider the question at all would see the delegation as being to the management company. This is, in our view, true not only of the mutual funds organized by brokerage firms and trust companies to which we refer in paragraph 6.02, but also of mutual funds organized in the manner of the Commonwealth funds. As a practical matter, and regardless of the legal forms used, mutual funds rarely, if ever, function as entities separate from their management companies. The incident discussed in the next section is not inconsistent with this conclusion; indeed, and in spite of their extraordinary nature, some of the developments there described lend support to the conclusion.

6.05 Our belief that the mutual fund is the method whereby the management company provides the service of investment management to investors is relevant in the determination of our approach to regulations. It accentuates the importance of the management company's position. If the mutual fund were an independent entity which negotiated with the management company to obtain investment advice for a fee, those responsible for the operations of that independent entity might be expected to take appropriate precautions in order to protect the assets of the mutual fund. In fact, such precautions must be taken by the management company.

6.06 If a mutual fund investor considered the risks he was prepared to accept in his investment, the only one he would consciously accept would be that his money might be partially or wholly lost as a result of a market decline or of investment decisions which turn out to be mistaken although made in good faith. He would not be prepared to accept the risk of investment decisions made in bad faith for purposes other than the good of the mutual fund; of theft; or of loss through bankruptcy or other misadventure which affects his salesman or anybody else who handles his money before it reaches the mutual

fund. More precisely, he would wish to assume that such risks had been reduced to the minimum by appropriate precautions designed to prevent their occurrence. In our view, requirements to ensure that such precautions are taken form a necessary part of any regulatory scheme designed to provide protection for the mutual fund investor.

6.07 The risks referred to in the preceding paragraph result from various possibilities. Through no fault of the responsible persons, the mutual fund, management company or distribution company could encounter financial misfortune, thereby preventing fulfilment of their obligations and exposing the shareholders or unitholders to the possibility of serious loss. Alternatively, those persons with access to assets of the mutual fund might embezzle them, or the assets could be lost through theft or by fire. Finally, persons with the power to control investment decisions affecting the mutual fund might make those decisions so as to favour their own interests rather than the best interests of the mutual fund.

6.08 It could be said that the risks described in the preceding paragraph are associated with the separation of ownership from management, and are present to some extent with any public company managed by persons who do not also own it. In light of this, the contention could be made that it would be inappropriate to deal with such risks only in the context of mutual funds, without also dealing with them in the context of public companies generally. By equating the mutual fund with an integrated public company, that contention impliedly accepts the second of the two philosophies described earlier in this chapter, and is therefore not in accord with our belief that the mutual fund is used by the management company to provide the service of investment management. The divorce between ownership and management is more complete in the mutual fund context than with other public companies, for the mutual fund participant has no voice at all in the affairs of the management company. This alone would provide adequate reason for rejection of the contention described above. That contention should also be rejected because mutual funds are financial institutions, and governmental controls to prevent misuse of assets have traditionally been more rigorous with financial institutions than with other public enterprises.

6.09 The best protection against the types of risks here being considered would be an arrangement whereby the management company and the distribution company were subjected to continuing independent scrutiny over their operations. The scrutiny might be provided by the mutual fund investors, or by a surrogate acting on their behalf; what is essential is that the procedure used be effective but not interfere unduly with the freedom of management to make investment decisions. Such an objective is obviously difficult to attain in a workable fashion, but a number of techniques have been proposed for the purpose. This chapter is devoted to a consideration of those techniques. Some of them are inconsistent with our view that the mutual fund is used by the management company to provide the service of investment management. We are not deterred by that fact from considering them on their merits; if satisfied that a technique would effectively provide continuing scrutiny and was workable, we would recommend its adoption in spite of a philosophical inconsistency.

6.10 An important matter for consideration in connection with continuing scrutiny, as with most of the questions considered in this report, is disclosure. It has been well said that sunlight is the best of disinfectants and electric light the best policeman, and it may be asked why disclosure is not alone sufficient for the provision of continuing scrutiny. We accept the value of disclosure; many of the substantive recommendations made in this report would be much more rigorous were we not satisfied that implementation of our recommendations would significantly improve the quality and effectiveness of disclosure. There are two reasons why we do not regard disclosure as sufficient of itself to provide continuing scrutiny over management. The first is the practical impossibility of providing comprehensive information as to all transactions on a clear and understandable basis at reasonable cost. This problem is commented on in paragraph 6.26. The second is that disclosure alone is of little or no value unless there is some independent person in a position such that he has not only power but also motivation or responsibility to take appropriate action to resolve abuses that are disclosed. This condition is not easily satisfied, and much of the following discussion is concerned with it.

6.11 This chapter is devoted to a discussion of techniques by which continuing scrutiny might be provided with minimal governmental involvement. An adequate technique for that purpose would protect against each of the types of risk discussed in paragraph 6.07. In the following chapters we consider those types of risk separately. Chapter VII reviews requirements for admission to the industry and minimum solvency requirements designed to avoid involuntary financial problems; Chapter VIII reviews precautions which should be taken against losses through such risks as embezzlement and fire; and Chapter IX reviews the more subtle, but extremely serious, abuses which can occur when investment decisions are motivated by objectives other than the best interests of the mutual fund. The recommendations made in the four chapters will together provide a regulatory scheme which should protect against the risks referred to in paragraph 6.07 but not interfere unduly with management flexibility.

6.12 The discussion of techniques for continuing scrutiny in the remainder of this chapter begins with a review of a proxy battle for control of two mutual funds as an important example of the practical application of some possible techniques considered later in the chapter. Succeeding sections discuss independent directors, voting rights, the role of the auditor and other techniques that we have considered which might permit continuing scrutiny without the necessity of involvement by the appropriate administrator.

The Commonwealth-Channing Proxy Battle

6.13 Commonwealth International Corporation Limited and Commonwealth International Leverage Fund Ltd., referred to in this discussion as the Commonwealth funds of Montreal, are federally incorporated mutual funds. The facts concerning them are stated here as at 1966, but many are still accurate at the time of writing. Canadian Channing Corporation Ltd., referred to in this discussion as Canadian Channing, acted both as management company and distribution company under a contract with each of the Commonwealth funds of Montreal. In other words, the two mutual funds adhered to the general practice of separating their management and sales functions from the mutual fund, and did so by contract with a single outside organization. The contracts, dated

December 31, 1963, were expressed to be effective until December 31, 1966, and could only be terminated on that date if notice of intention to terminate was given before December 31, 1965. There were no relevant differences between the by-laws, or any other aspect of the organization and operations of the two mutual funds except for their investment objectives. Canadian Channing distributed the shares of the Commonwealth funds through a direct sales force which included over 300 salesmen at the time of the events discussed in the following paragraphs.

6.14 In the respects dealt with in the preceding paragraph, the organizational arrangements of the Commonwealth funds of Montreal were typical of Canadian mutual funds. In certain other respects, they were atypical. The mutual fund shares were the only shares issued, and carried full voting rights. As a result of the technicalities of company law referred to in paragraph 5.62 which require in the absence of a statutory provision to the contrary that mutual fund shares be preferred shares, and therefore necessitate the creation of an underlying class of common shares, each of the two mutual funds had an authorized class of common shares. Neither had issued any such shares, so that the mutual fund shares had full voting power.

6.15 The principal respect in which the Commonwealth funds of Montreal were atypical was that the majority of the members (nine out of twelve) of their boards of directors were independent businessmen. One of them was president of the two mutual funds. Their philosophy concerning the relationship of the mutual funds with Canadian Channing, as we understand it, is described in paragraph 6.03; briefly, they accepted responsibility for the operations of the mutual funds and regarded Canadian Channing as an advisor whose advice could be rejected. In the event of dissatisfaction they could terminate the advisory and distribution contract in accordance with its terms.

6.16 The quality of the relationship between the independent directors and Canadian Channing had declined during the late 1950's. The deterioration became more rapid starting in 1961, when as part of the industry-wide competition for salesmen, another mutual fund organization succeeded in attracting away from Canadian Channing its sales manager and a considerable portion of

its sales force. In July, 1965 the relationships were injured further when a proposed transaction under which the parent company of Canadian Channing, a United States company, would have sold control of Canadian Channing to another United States company was almost completed. The independent directors did not approve of the company which had proposed to effect the takeover, and were upset by the whole incident. From this time onwards the relationship between the independent directors and Canadian Channing was very bad. Investment advice given by Canadian Channing was frequently rejected, and information required by it to carry on the sales operation was refused.

6.17 In December, 1965, the parent company of Canadian Channing was taken over by another United States company. Both Canadian Channing and the independent directors had apparently realized some time before that a proxy battle would eventually occur between them and it is doubtful that this takeover materially affected matters. In the same month, the dispute reached a head. On December 16, 1965, the independent directors caused each of the Commonwealth funds of Montreal to give to Canadian Channing notice of intention to terminate the management contract. A similar notice was given on the same day by Canadian Channing to each of the mutual funds. The notice given by Canadian Channing was for tactical reasons only; it had no intention of terminating its relationship.

6.18 There followed a long drawn-out, expensive and bitter battle for control of the two mutual funds. We will not attempt here to describe the details of the battle, except in very general terms. The independent directors relied principally on solicitation of the shareholders by mail and sent out a large amount of literature at the expense of the mutual funds. Canadian Channing also sent out a considerable number of letters, but its proxy solicitation was effected principally through its direct sales force. Its salesmen were guaranteed minimum weekly rates of pay so that they would concentrate on proxy solicitation instead of selling, and they were effective in proxy solicitation. The costs incurred by the independent directors, and paid by the Commonwealth funds of Montreal (over a period of time in order not to contravene the Quebec Securities Commission policy on management fees and expenses

described in paragraph 10.16) amounted to approximately $350,000; those incurred and paid by Canadian Channing amounted to approximately $740,000.

6.19 Throughout the proxy battle the volume of redemptions was comparatively high. Redemptions of shares of the two mutual funds during 1966 equalled 15.4% of the aggregate of their total net asset value at the end of 1965 and their sales during 1966. The corresponding figure for all Canadian mutual funds having over $5 million in assets was 9.8%. It would appear that shareholders who disapproved of the situation tended to redeem their shares. It seemed probable at all times that Canadian Channing would attract a majority vote among those who remained shareholders. Presumably many factors influenced the majority to take this approach; the Commonwealth funds of Montreal had had a satisfactory performance record and that fact combined with the effect of direct approaches by salesmen may have been the most significant factors in the decision. The independent directors relied largely on their own abilities; on the fact that they had negotiated with Canadian Channing a more favourable management fee; and on allegations of bad faith on the part of the Canadian Channing organization.

6.20 A number of technical problems arose during the proxy battle and the shareholders' meetings connected therewith. Two trust companies held shares of the Commonwealth funds of Montreal, one as trustee for shareholders who reinvested their dividends and did not demand share certificates representing the reinvested dividends, and the other as trustee for purchasers of contractual plans. These two trust companies encountered difficulties in determining for whom they should vote. The difficulties were compounded for at least one of them when the independent director who, as president of the two mutual funds, was to act as chairman of their pending shareholders' meetings, issued what the trust company considered to be incorrect instructions on the manner in which shares were to be voted at the meetings. Protracted litigation over this and other problems delayed a final resolution of the battle and

increased the costs for both sides.* When the shareholders' meetings were finally held, Canadian Channing was overwhelmingly successful, winning 3.5 of 5.6 million votes cast in Commonwealth International Corporation Limited and 1.3 of the 1.8 million votes cast in Commonwealth International Leverage Fund Ltd.

6.21 We venture no opinion on the relative merits of the positions adopted by the independent directors and by Canadian Channing. No abuse by Canadian Channing of its position was established, and the contention of the independent directors was essentially that Canadian Channing was not the best available management company, and should either reduce its fee for the same services or permit another company to replace it. Canadian Channing pointed to the record of performance by the two mutual funds, alleged that the record would have been better if the independent directors had accepted certain investment advice which they in fact rejected; and stated that in any event the shareholders had purchased their shares in reliance on the management of Canadian Channing, and prior to the commencement of the proxy battle had not evinced any serious dissatisfaction by redeeming. It is of interest that the latter argument reflects the first of the two philosophies set out in paragraph 6.01 as to the nature of management company-mutual fund relationship, although the organizational arrangements of the Commonwealth funds of Montreal were more consistent with the second philosophy. The success of Canadian Channing in the ultimate vote might be attributed to acceptance of its position by the shareholders, but as a practical matter was probably due more to the efficiency of its proxy solicitation through the direct sales force and to the apparent tendency of dissatisfied shareholders to redeem rather than cast negative votes.

6.22 The Commonwealth proxy battle is, in our opinion, important as a practical application of three of the techniques considered in following sections for the provision of continuing scrutiny over mutual fund management. The three are the right to redeem; independent directors; and voting rights.

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* Two of the judgments delivered in the course of the series of judicial hearings have been reported:
Re Zimmerman and Commonwealth International Leverage Fund Ltd. and Commonwealth International Corporation Limited, 56 D.L.R. (2d) 709; and
Re Zimmerman and Commonwealth International Leverage Fund Ltd. et al, 58 D.L.R. (2d) 160.

References to the proxy battle are made in the next three sections, which discuss those three techniques.

The Availability of the Right to Redeem

6.23 It is frequently stated by members of the mutual fund industry that the best continuing control over their practices, apart from their own abilities and standards, is the possibility that annoyed shareholders or unitholders might "vote with their feet" by presenting their shares or units for redemption. This would result in a reduction of total net assets and hence of the management fee. The power to redeem held by their shareholders or unitholders is one of which investment managers are always cognizant, and its importance to mutual fund operations cannot be denied. We accept that in extreme cases it might be an effective protection against abuses, but for a number of reasons we have concluded that reliance cannot feasibly be placed upon it to provide the type of continuing scrutiny that we feel to be desirable.

6.24 The Commonwealth-Channing proxy battle provides a good example of the deficiencies in the power to redeem as a continuing control over management. As indicated in paragraph 6.19, the volume of redemptions was unusually high during the proxy battle; presumably the redeeming shareholders were in large part dissatisfied, but it is noteworthy that they redeemed rather than vote against the continuance of existing management. The availability of the right to redeem can be advanced as an argument against reliance on voting rights to contribute to effective continuing scrutiny over management. Redemptions by dissatisfied shareholders or unitholders are likely to be far less effective as a control over management than would be their active opposition as continuing shareholders or unitholders.

6.25 There are other difficulties inherent in the belief that the right to redeem will provide adequate scrutiny over management. It assumes that such scrutiny will be provided by the shareholders or unitholders themselves through the study of information disclosed to them and the exercise, when necessary, of their right to redeem. We think that this assumes too much, for implicit in it are two further assumptions. These are that mutual fund shareholders or unitholders possess the ability and knowledge necessary to conduct a

continuing review of management's activities, and that the disclosure requirements can be made sufficiently detailed to ensure that full information is provided as to all relevant activities. Nothing in the results of the consumer survey conducted under our auspices inclines us to accept the first assumption.

6.26 The second assumption, that disclosure requirements can be made sufficiently detailed to provide shareholders or unitholders with full information as to all activities, is in our opinion also fallacious. A seemingly innocuous transaction may be abusive for any of a number of reasons. The price paid or received; the relationship between the management company and the other party to the transaction; the service fees and commission paid: any of these or other factors may be such as to at least require further explanation. It would in our view be impracticable to require that information be supplied to mutual fund shareholders or unitholders in sufficient detail to facilitate

6.27 Even if the difficulties described in the preceding paragraph are overcome, two additional factors would have to be present before reliance could be placed on the combination of disclosure and the right of redemption to provide continuing scrutiny over management. The first factor would be that mutual fund shareholders and unitholders would expend the time and effort necessary to make a complete review of material sent to them to ensure that management was paying proper attention to its responsibilities. The mutual fund shareholder or unitholder is almost by definition a person who is unwilling or unable actively to participate in the management of his own investments, and it seems unlikely that many of them would contribute this degree of time and effort.

6.28 The second additional factor which must be present is that the dissatisfied mutual fund shareholder or unitholder would exercise his right to redeem without hesitation. Such will often not be the case, because he is often in a position where he will suffer a significant loss if he redeems. This is particularly true in the early stages of a contractual plan, when up to 50% of the first twelve to fifteen instalments may be deducted on account of sales charges, but it is also true with most shares or units purchased on a lump sum basis where the amount deducted is usually in the neighbourhood of 8.5%.

6.29 It might be said that so long as some mutual fund shareholders or unitholders carefully follow the progress of the mutual fund and exercise their right to redeem when and if deficiencies in management's performance become apparent, that is all the protection necessary. Even if it could be established that an appreciable percentage of shareholders or unitholders follow such practices, we would hesitate to rely on that fact. To do so would amount to a policy of devil take the hindmost, accepting that the more sophisticated and wealthy investors should redeem first and leaving the investors most requiring protection in the least advantageous position.

6.30 For the reasons set out in this section, we have concluded that, while emphasis should be placed on the importance of disclosure, it should not be assumed that disclosure coupled with the availability of the right to redeem will provide adequate continuing scrutiny over the management of mutual funds.

Independent Directors

6.31 For reasons indicated in the preceding section, we have concluded that mutual fund shareholders or unitholders should not be relied upon to provide the degree of continuing scrutiny over management which is the objective of the techniques considered in this chapter. In the next section we propose that they be given power to vote on certain matters, and the exercise of that power may resolve major difficulties; it would, however, be ineffective to deal with most of the types of risk described in paragraph 6.07. It is, then, appropriate to consider whether a surrogate can be relied upon for the provision of continuing scrutiny. In this section we consider the most oft-suggested surrogate, members of mutual fund boards of directors who are unaffiliated with management; later in this chapter we discuss the extent to which an independent trustee, or the mutual fund auditor, should be relied upon to fulfil the role of surrogate.

6.32 In the consideration of independent directors, the question we must resolve is not whether they are desirable but whether they should be imposed on the mutual fund industry by legislative fiat. The very existence of a separate board of directors for the mutual fund may seem inconsistent with the philosophy of the mutual fund as the method whereby the management company sells investment management. The inconsistency is, however, more apparent than actual in view of the wide scope of powers entrusted to the management company under the management contract, and the even wider powers ordinarily exercised by it in practice. In addition, we think that there are certain obvious advantages to a mutual fund and its shareholders in a board of directors that includes at least some members who are independent of management. These members can assist management by subjecting its decisions to informed and impartial review, perhaps with the additional benefit of comments based on backgrounds in other business activities. It can protect shareholders or unitholders by ensuring that management properly performs the duties for which it is paid. For all these reasons, we support the use of independent directors on a voluntary basis by mutual funds. This does not resolve whether their use should be required.

6.33 In the United States, Congress has decided that the advantages of independent directors are so significant as to justify the imposition of a statutory requirement. The Investment Company Act of 1940 provides that at least 40% of the members of the board of directors must satisfy a statutory standard of independence. That Act also imposes certain responsibilities on the independent directors. The Securities and Exchange Commission has said of these requirements: "The function of these provisions with respect to unaffiliated directors is to provide an independent check on management and to provide a means of representation of shareholder interests in investment company affairs".*

6.34 There is presently no Canadian legislation equivalent to the 1940 Act requirement referred to in the preceding paragraph. The Canadian Mutual Funds Association specifies in its regulations that:

> 1(b) At least 40 per cent of the directors of a mutual fund shall be independent directors who are neither directors, officers,

* Public Policy Report (<u>supra</u>, footnote to paragraph 1.07), pp. 332-333.

employees or equivalents, of the management company or the underwriter or contractual distributor of the mutual fund.

No attempt is made in the regulations to define in greater detail what constitutes independence of a director. Several members of the C.M.F.A. rely on a restriction to this rule which permits any member whose board of directors did not comply with the rule on the day the regulation became effective "to continue on its present basis provided that all subsequent board appointments shall be limited to the above requirements until such time as the requirements of this section have been met". While the rule applies to trusteed mutual funds (the term "directors of a mutual fund" is defined to include "the governors, or their equivalents" of all member mutual funds) some member mutual funds organized as trusts have relied on the quoted exception to justify non-compliance. Other trusteed mutual funds have created boards of governors with ill-defined responsibilities.

6.35 In their application of the regulatory requirement for independent directors, C.M.F.A. members interpret independence in a variety of ways, which indicates to us that the definition of what constitutes independence would have to be considerably more precise than that contained in C.M.F.A. regulation 1(b) if the requirement were to be made statutory. This is of particular importance in view of the fact that the selection of the independent directors would ordinarily be in the hands of management through its control over the proxy machinery.

6.36 Because of the C.M.F.A. rule described above, and because of the influence on the Canadian mutual fund industry of practices followed in the United States under the 1940 Act, many Canadian mutual funds have boards of directors composed at least in part of persons who may be regarded as independent of management. While estimates are affected by the definition of what constitutes independence, the Commonwealth funds of Montreal are among the very few that have had boards of directors a majority of whose members were persons who could reasonably be regarded as independent.

6.37 The imposition of a statutory provision for the independence of a specified percentage of mutual fund boards of directors involves two requirements: that each mutual fund must have a board of directors, and that a specified percentage of the members of each board must be independent of management. Serious difficulties arise in the application of each requirement. Some indication of the nature of these difficulties may be gained from developments in the United States. The 1940 Act requirements are implemented by provisions which define the required degree of independence; the most important elements of these provisions are set out in a footnote.* The Act also requires that certain actions must be approved by a majority of the independent directors. These provisions have been in effect for almost thirty years, and it should now be possible to make some assessment of their efficacy. Considerable assistance in this assessment may be obtained from comments made by the Securities and Exchange Commission.

6.38 The S.E.C., in its Public Policy Report, reviews judicial decisions which held that individuals having certain types of economic relationships with the management company or the mutual fund were not affiliated within the meaning of the definition. The Report continues as follows:

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* Section 10(1) of the Investment Company Act of 1940 provides that "no registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are investment advisors of, or officers or employees of, such registered company." The Act further prohibits investment companies from retaining as a "regular broker" or as a "principal underwriter" any of their directors, officers or employees, or any persons of which any one of them is an affiliated person, unless the majority of the board consists of persons other than the regular brokers, the principal underwriters or their affiliated persons. A similar restriction applies to directors who are the investment bankers. The definition of "affiliated person" in section 2(a)(3) of the Act reads as follows:

> "Affiliated person" of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

> Regardless of whether the economic ties of the fund directors involved in these cases were sufficient to demonstrate that they were "controlled" by the investment adviser, principal underwriter, or regular broker, such close relationships derogate from directors' ability to represent effectively the interests of shareholders. In the Commission's view the disinterested representation of shareholders in the management of investment companies constitutes an important investor protection, even though, as the Act is now written, unaffiliated directors are not in a position to deal effectively in the areas of management compensation, allocation of brokerage, and the setting of sales load levels. In these areas other steps, such as proposed by the Commission, are the sine qua non of adequate protection of investment company shareholders.*

6.39 The Public Policy Report recommends as additions to the definition of affiliated directors a number of additional tests designed to ensure the genuine independence of the directors selected. It is not necessary to review these additions here; they would extend and add to the complexity of the already complicated rule by superimposing a definition of "interested person" on the definition of "affiliated person" set out in the footnote to paragraph 6.37. As indicated in the above quotation, the S.E.C. was not satisfied that independent directors could deal adequately with the three problem areas therein mentioned, and recommended separate legislative provisions in these areas.

6.40 Difficulties in application of the concept of independence are indicated by the developments outlined in the preceding paragraphs. Other problems have arisen in the United States with the necessary second branch of the requirement for independent directors, that the mutual fund must have a board of directors. These have been considered in the context of variable contracts of life insurance companies and of mutual funds sponsored by banks and organized in a manner similar to that of investment funds of Canadian trust companies. They have been resolved to the complete satisfaction of nobody; the companies affected would prefer to treat the funds involved as managed accounts, while the S.E.C. would, ideally, like them to be separate entities.

6.41 We think three conclusions can fairly be drawn with respect to the concept of independent directors on the basis of the experience described above. First, the use of independent directors in the United States has not resolved the problems inherent in the separation of management from ownership in

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* Public Policy Report (<u>supra</u>, footnote to paragraph 1.07), p.334.

the context of mutual funds. Second, it is clear that independent directors have not been able to deal adequately with the matters regarded by the S.E.C. as major problem areas, mentioned in the quotation in paragraph 6.38. Third, it seems apparent on the basis of experience both in Canada and in the United States that any effective requirement for the independence of directors would have to include a very wide and rigorous test of independence. The selection of directors is ordinarily in the discretion of the management company through its control over the proxy machinery, and in the absence of such a definition of independence it could avoid the spirit of the legislation.

6.42 Difficulties in the application of a requirement for independence of directors would arise not only with the criteria for independence, but also with the necessary second branch of the requirement, that each mutual fund must have a board of directors. The latter would impose greatest inconvenience in Canada in its application to the trust company investment funds, for it would result in the isolation of these funds from the ordinary operations of trust companies through their treatment in very different ways. These problems are not insuperable; a requirement that there be a board of directors for every mutual fund could be successfullly enforced. However we hesitate to recommend the imposition of the requirement unless satisfied that the results would be beneficial. We are not so satisfied.

6.43 Apart from the problems shown by experience to exist, we are concerned with a question of principle inherent in the application of a requirement for the independence of directors. We question whether government should require that persons without a direct stake in the success of the operation be put in a position where they are expected to pass on the business judgment of the management company. This point of principle serves to fortify us in a decision that would in any event be dictated by the other considerations discussed above.

6.44 For the reasons set out in this section, we have concluded that there should be no statutory requirement that each mutual fund have a board of directors or equivalent body, and no statutory requirement that a specified percentage of the members of such bodies be independent of management. This

conclusion is not relevant to the establishment of such arrangements on a voluntary basis or through self-regulation, developments which we think desirable.

Voting Rights

6.45 Perhaps the most important right accorded shareholders under most corporations acts is the right to vote. It is through this right that shareholders, at least in theory, are intended to exercise continuing control over management; the right is also of indirect value in the provision of continuing scrutiny, since information must be supplied to shareholders so that they can consider the matters upon which they are expected to vote. For purposes of analysis, the matters with respect to which this right is conferred can be divided into three categories. The first category includes the election of directors to conduct the management of the company on behalf of the shareholders. It also includes any votes in which the participants pass upon the quality of management; a good example would be the acceptance of the financial statements for the preceding year, in jurisdictions that require such statements to be accepted by the shareholders. For convenience, in the following discussion votes falling within this category are referred to as those for the election or approval of management.

6.46 The second category of matters upon which shareholders are accorded statutory voting rights includes actions that are regarded as so extraordinary that they should not be implemented solely on the authority of the directors. The nature of these matters differs among jurisdictions. Usually included in this category are the sale of a substantial portion of the company's assets; the authorization of new securities for issuance by it; and major amendments to its by-laws. Approval by vote of the shareholders is required before these steps can be taken by the company. Votes on matters within this category are precipitated by a decision of the board of directors who request that the shareholders approve a particular action. For convenience, in the following discussion such votes are referred to as those for the approval of actions proposed by management.

6.47 The third and smallest of the categories of matters upon which votes may occur includes all cases where the shareholders act on their own initiative rather than through or at the suggestion of the directors. Examples, which again vary among corporations acts, include meetings called by the shareholders to dismiss the board of directors, or to force the winding up of the company. The matters upon which shareholders may take such independent action are ordinarily very limited, and votes of this type are comparatively rare. Votes included in this category are referred to in the following discussion as votes on shareholder-initiated actions.

6.48 The shareholders or unitholders of most Canadian mutual funds do not have the power to vote on matters within the first of the above three categories, the election or approval of management. Such powers are almost unknown among unincorporated mutual funds; shareholders of a number of incorporated mutual funds have power to vote for the election of directors, but in many cases the value of that power is substantially reduced by the rights attached to the underlying class of common shares issued to the organizers or their successors. These shares sometimes have voting power superior to that of the mutual fund shares sold to the public; in other cases the holding of such a share is made a precondition to election as a director. In these and other ways the common shares, theoretically created for the technical reasons described in paragraphs 5.62 and 5.63, are used to negate the value of voting rights on the mutual fund shares.

6.49 The question whether shareholders or unitholders should be accorded by statute the power to vote for the election or approval of management has caused us considerable concern. As with independent directors, the problem is not whether the arrangement would be desirable but whether it should be required by legislative fiat. Our conclusion in the preceding section that we should not recommend a requirement for each mutual fund to have a board of directors or equivalent body would be inconsistent with the usual type of voting rights for the election or approval of management, under which shareholders annually elect the board of directors. This does not resolve the problem since it would be consistent with that conclusion to require that the approval of

shareholders or unitholders be obtained for the management contract. The management company is entrusted with such wide powers over the operation of a mutual fund that approval of the management contract can for present purposes be equated with election of the board of directors in other public companies.

6.50 In the United States, the Investment Company Act of 1940 requires that the management contract be submitted to the holders of shares or units for their approval at least once every two years. The experience under this provision is indicated by the following quotation from the Public Policy Report:

> The shareholders' opportunity to accept or reject management and shareholder proposals can provide them with meaningful alternatives in connection with most matters for which their approval is solicited. As a practical matter, however, these alternatives do not exist in connection with shareholder approval of advisory contracts. Proxy contests initiated by competing investment advisers have taken place only in very rare instances where existing management relationships have completely broken down. The shareholders themselves cannot select a new adviser, formulate a new advisory contract or set a new advisory fee; only the fund's board of directors and the shareholders acting together can do that. The shareholders alone can only ratify or refuse to ratify what management proposes. Shareholder refusal to adopt or renew the contract proposed by management, however, might leave the fund without an effective advisory contract, and the Act provides that no person or organization may serve as an investment adviser to a registered investment company except pursuant to a written contract. Thus, exercise of the shareholders' right to refuse to ratify the adoption or the renewal of an advisory contract is fraught with uncertainty for -- and possibly with harm to -- the fund's operations. The drastic consequences that may attend the exercise of that right impair its effectiveness as a control over advisory fees.*

The lack of success in the United States of this requirement weighs against the adoption of a similar requirement in Canada. In addition, it is relevant that such a requirement would be consistent with the second rather than the first of the two philosophies described in paragraph 6.01, although the first of those philosophies is the one with which we agree.

6.51 In spite of the factors referred to in the preceding paragraph, we have concluded that a requirement similar to the 1940 Act provision described above should be adopted for application to Canadian mutual funds. In our opinion, it is reasonable that management should make an accounting to shareholders or unitholders at least once in every two years. Such a procedure will

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*Public Policy Report (supra, footnote to paragraph 1.07), p.129.

provide a method for the dismissal of management in a very serious case, and its value will be established if it ever facilitates the dismissal of an inefficient management company. This emphasis on the management contract will be consistent with the procedures of mutual funds whether or not they have boards of directors; a mutual fund which has a board of directors can deal with the election of directors and the approval of the management contract at the same meeting.

6.52 If the requirement for approval of management contracts is to attain even the comparatively narrow objectives outlined in the preceding paragraph, a procedure must be found to provide a meaningful alternative for shareholders or unitholders at the time the management contract is submitted to them. The difficulties described in the quotation from the Public Policy Report in paragraph 6.50 would otherwise be insuperable. We return to this question in paragraphs 11.28 to 11.37, where we make proposals to deal with this problem. Such proposals should be combined with those concerning voting procedures established in accordance with paragraph 6.57 to arrive at the legislative scheme for approval of management contracts.

6.53 The objections that can be raised to votes in the second of the three categories described in paragraph 6.46, those for the approval of actions proposed by management, are not as serious as the objections to votes for the approval of the management contract outlined in paragraph 6.50. The fact that such votes relate to decisions on specific actions proposed to be taken rather than to assessments of management quality on the basis of past events makes it less likely that a shareholder or unitholder would withdraw through redemption rather than vote against management. No major administrative or procedural difficulties would be involved in their application. Finally, we think that votes of this type could be of significant value in dealing with specific types of problems whenever they arise.

6.54 It is also relevant that votes for the approval of actions proposed by management are fully consistent with the philosophy that the mutual fund is the method whereby the management company sells its investment advice. A change in the terms upon which the investment advice is provided should be approved by those affected. They entrust their money for management on a

specified basis, and should be given an opportunity to reconsider when the terms are changed. It might be said that their only option in the event of disapproval of a proposed amendment should be to withdraw from the mutual fund. We have considered this approach, and have decided against it. In our view, the organizers of a mutual fund assume certain continuing responsibilities through the acceptance of money for investment on a long-term basis. To permit arbitrary changes in the arrangements made at the outset, with no option for the investors but to withdraw, would be inconsistent with such responsibilities. We are fortified in this conclusion by the factor referred to in paragraph 6.28, that some investors might be reluctant to withdraw since they would thereby lose their sales charges. However, we regard the conclusion as appropriate even in the context of mutual funds the shares or units of which are sold without sales charges.

6.55 We have concluded that votes of shareholders or unitholders should be required for the approval of certain types of actions that may be proposed by management. The actions for which we think this treatment should be provided are somewhat different from the types of actions usually so treated under corporate law, because of the differences in the mode of operation of mutual funds. Only a few types of actions should, we feel, fall within this category. They are merely listed here, and are discussed in detail in the indicated paragraphs elsewhere in this report. The following actions are included: material amendments to the management or distribution contract (paragraphs 11.11 to 11.14), or to the statement of investment objectives and practices (paragraphs 12.95 to 12.99); transfer of the management contract (paragraphs 11.16 to 11.27); and where required by the appropriate administrator, the dismissal of the mutual fund auditor (paragraph 6.87), and amendments to the agreement for custody of assets of the mutual fund (paragraphs 8.05 to 8.24). Each type of action should be prohibited unless the approval, in writing or at a meeting, of the holders of a specified percentage of outstanding shares or units as at certain record date is obtained. Implementation of this requirement would provide shareholders or unitholders with significant protection against material changes in the method of operation of the mutual fund.

6.56 We have considered whether facility should be provided for the third category of votes, described in paragraph 6.47, being votes on shareholder-initiated actions. In our opinion, adequate protection against major adverse actions by management would be provided by the voting rights proposed earlier in this section, and little would be added to the quality of available protection by permitting votes to be initiated by shareholders or unitholders. We have therefore concluded that provision for holders of shares or units to call for votes on specified matters without prior action by management are unnecessary.

6.57 To implement the conclusions reached concerning votes for the election and approval of management and votes for the approval of actions proposed by management, it will be necessary for the relevant legislation to include procedural requirements for voting. We have considered whether to recommend a complete code of procedure for that purpose. The legislation presently applicable to incorporated mutual funds includes such provisions, which do not differ in principle among the Canadian jurisdictions. Additional provisions will be necessary for application to unincorporated mutual funds, and it seems desirable for them to be uniform with the corresponding requirements of corporations acts. We have concluded that it is unnecessary to propose a detailed scheme for application to mutual funds. The relevant sections of corporations acts in each jurisdiction should apply to incorporated mutual funds, and similar provisions should be enacted for application to unincorporated mutual funds. In all cases, the requisite percentage to be obtained should be a simple majority of those shares or units voted at a meeting, or of those outstanding if the vote is taken by mail. The recommendations in Chapter V would make it irrelevant whether the majority was expressed to be by number or dollar value of shares or units.

6.58 The only exceptions to the approach proposed in the preceding paragraph are the specific suggestions made in paragraphs 11.32 to 11.37 which are designed to ensure that it is possible for an alternative management contract to be presented to the meeting called to approve a management contract.

We have concluded that provisions of the type there described are not essential for votes for other purposes; such votes should be regarded as requests by the management company made to the holders of shares or units for their consent to a change in the terms of management.

6.59 For the reasons set out in this section we recommend:

(1) that the management contract of a mutual fund should be submitted to the holders of its shares or units for their approval at intervals of not more than two years;

(2) that none of the following actions should be permitted without prior approval of the holders of shares or units of the mutual fund concerned:

(a) material amendments to the management or distribution contract [paragraph 11.15, recommendation (7)] or to the statement of investment objectives and practices [paragraph 12.100, recommendation (4)] ; and

(b) where required by the appropriate administrator,

(A) the dismissal of the mutual fund auditor [paragraph 6.88, recommendation (13)] ; and

(B) amendments to the agreement for custody of assets of the mutual fund [paragraph 8.24, recommendation (10)] ;

(3) that legislation which implements these recommendations should specify the voting procedures to be followed, which should be substantially the same for incorporated and for unincorporated mutual funds; the requisite approval should be by a simple majority of shares or units voted, if the vote is taken at a meeting, or of shares or units outstanding if the vote is taken by mail; and

(4) that the additional provisions recommended in paragraph 11.38 should be applicable to votes of the type contemplated by recommendation (1).

Independent Trustees with Supervisory Powers

6.60 In paragraphs 6.31 to 6.44 we consider the use of independent directors, who are relied upon in the United States to act as surrogates on the part of mutual fund investors. The regulations applicable in Great Britain to unit trusts, the equivalent of mutual funds, rely on a trustee for that purpose. The responsibilities of this trustee go beyond those of a custodian, for a custodian is ordinarily responsible only to confirm that the organization for which it acts actually possesses the assets it claims to own; the trustee of a unit trust must not only do this but must also review investments made by the unit trust to ensure that they meet certain standards. The differences between the two are indicated, and the responsibilities held by the trustee of a unit trust are summarized, in the following quotation from an English text:

> The Investment Company Act, 1940, required investment companies to provide security arrangements for the underlying securities of their portfolios satisfactory to the S.E.C., or to deposit such securities with a trustee approved by the S.E.C. The sole function of such trustees is that of custodian. Trustees of British unit trusts have many other duties to perform; in general they are watchdogs of the interests of the unit holders, and make sure that the provisions of the trust deed and the provisions of the Prevention of Frauds (Investment) Act, 1958, as implemented by the Board of Trade regulations, are not violated. Depending upon the provisions of the trust deed, the main duties of trustees are: to buy and sell underlying securities on instruction from the management, but to veto investments if not permitted by the deed, or if they consider them not to be in the best interests of the unit holders; to see that distributions are not inflated by underlying securities always being bought cum dividend and sold ex dividend; to receive the income of the fund and distribute it to the unit holders; to maintain and keep up to date a register of unit holders; to see that no certificate of units is issued before they are possessed of equivalent asset value; to take steps to remove management from office on good cause; and to be satisfied with sales promotion literature before it is used. All these duties are not necessarily assumed by all trustees, and trustees probably try to keep their responsibilities down to a minimum. The trustees in Britain are mostly high quality banks, especially the Big Five, and high class insurance companies. They receive fees for their services which are normally paid out of the gross remuneration of managements.*

While trustees may try to keep their responsibilities down to a minimum, they are unlikely to be successful. Public solicitations for the sale of units in a unit trust are not permitted until its trust deed has been accepted by the Board of Trade. The Board will not accept a trust deed unless it is satisfied with

* Corner, D.C. and H. Burton, Investment and Unit Trusts in Britain and America, (Elek Books, 1968), p.12.

the trustee; it also reviews the trust deed to ensure that the appropriate responsibilities are conferred on the trustee.

6.61 It is of interest that reliance on a trustee as described in the above quotation, unlike the use of independent directors, is fully consistent with the philosophy that the mutual fund is the method whereby the management company sells its investment advice. It is also important to note that the incorporation into the regulatory structure of requirements such as described in the quotation would be a decision with implications at least as far-reaching as reliance on independent directors. It would go far beyond the narrow question of custody of assets, dealt with in the next chapter. If successfully implemented, the use of independent trustees would resolve the principal problems inherent in the separation of management from ownership in the context of mutual funds.

6.62 We were attracted for a number of reasons by the use of independent trustees to scrutinize the operations of mutual funds. It would provide a self-enforcing method to deal with a number of aspects of mutual fund operations which could cause problems in exceptional cases but are perfectly routine matters in the great bulk of well-administered mutual funds. The restriction on flexibility of industry operations would be minimal, since the trustee could be given discretionary powers and would have adequate resources to maintain a continuing review of developments. The nature of the responsibilities that could be entrusted to the trustee would be different from those which could feasibly be applied by a governmental regulatory body, since the latter is bound by procedural requirements not applicable to a trustee. Finally, should governmental administration of the regulations we propose be carried out on a provincial basis, some of the resultant problems of divided jurisdiction could be avoided through a requirement that the trustee used by a mutual fund be one qualified to do business in each province in which the mutual fund is itself registered.

6.63 A detailed explanation of the form of organization of the unit trust is not necessary for present purposes, but it is important to note in connection with the feasibility of adoption in Canada of reliance on independent

trustees that the unit trust is a trust rather than a company. In paragraph 1.57 we briefly outline the form of organization of trusteed mutual funds in Canada. As there noted, it is necessary to distinguish the mutual fund organized by agreement of trust entered into by a management company with a trust company as trustee, from the investment fund organized by a trust company through a declaration of trust. The unit trust is organized in the former rather than the latter fashion, although the organizational details and particularly the responsibility assumed by the trustee are very different from present Canadian practice. The regulatory assignment of responsibility to trustees in Great Britain was a natural development given the fact that all unit trusts were associated with a trustee by reason of their form of organization. In Canada this is not true of incorporated mutual funds, and is not true in the same way of investment funds organized by trust companies since the only trustee with which such investment funds are associated is the organizing trust company. To require the use of independent trustees in Canada would therefore necessitate considerable changes in the methods of operation of all incorporated mutual funds, all trust company investment funds, and some other trusteed mutual funds.

6.64 In spite of the advantages to be gained through adoption of the procedure followed in Great Britain, we have concluded that its adoption in Canada would not be feasible. This conclusion is attributable to several factors, of which the first is that of cost. The initial costs in particular would be substantial for those mutual funds required to make the changes in their methods of operation described in the preceding paragraph. The substantial increase in the extent of the obligations of trustees would result in a commensurate increase in their costs and the fees they would charge for their services. The increased costs would inevitably be paid, directly or indirectly, by mutual fund participants.

6.65 The second difficulty lies in the determination of what organizations would be permitted to assume the responsibility of trustees under the proposed procedure. The permitted category would presumably be limited to trust companies, but there is a proliferation of trust companies in Canada of all

sizes and degrees of competence. It is clear to us that the selection of a trustee would have to be approved by the appropriate administrator, not only to ensure its competence but to verify that it was in fact in an arm's length relationship with the mutual fund and the management company. Such decisions would be of considerable difficulty, and to the extent that reliance is placed on the trustee in the regulatory structure the participants in the mutual fund might suffer as a result of use of an inappropriate trustee.

6.66 Another problem with the proposed procedure lies in the competitive anomalies that would result from its introduction. The most obvious example, but far from the only one, is that decisions concerning a trust company investment fund would be scrutinized by a trust company other than the one responsible for its organization. Other competitive problems would arise in large numbers, because trust companies act in a multitude of capacities that require them to trade in securities; to confer upon one organization which is actively engaged in trading the responsibility to supervise the transactions of another organization similarly engaged would inevitably lead to unsatisfactory results. This is particularly true in view of the fact that there is no historical tradition for the assumption of this type of responsibility by Canadian trust companies.

6.67 Finally, we are troubled in this context as with independent directors by the point of principle described in paragraph 6.43. Independent trustees, like independent directors, would be persons without a direct stake in the success of the enterprise who would be expected to pass on the business judgment of the management company. We hesitate to recommend a requirement with such a result. For this and the other reasons set out above, we have concluded against a recommendation in favour of Canadian adoption of a requirement similar to that described in the quotation in paragraph 6.60.

6.68 For the reasons set out in this section, we have concluded that there should be no statutory requirement in Canada for an independent trustee with supervisory powers to be associated with each mutual fund; this conclusion does not relate to the question of custody of assets, considered in Chapter VIII.

The Auditor

6.69 In paragraphs 6.31 to 6.44 we consider and reject the use of independent directors, and in paragraphs 6.60 to 6.68 we consider and reject the use of an independent trustee, to act as surrogates on behalf of mutual fund investors. While the mutual fund auditor cannot assume the scope of responsibility that could be exercised by a director or trustee, his role can be of great importance. In this section we discuss the extent to which reliance can appropriately be placed on him to provide continuing scrutiny in the absence of an effective surrogate for that purpose. We are here concerned only with the selection of the auditor and his duty to report to shareholders and unitholders. In Chapter VIII, particularly paragraphs 8.68 to 8.76, we conclude that the auditor should be given responsibilities in connection with the continuing inspection programme of administrators.

6.70 The position of the auditor as the only "outsider" who is in a position to conduct a complete review of the records, accounts and procedures of the mutual fund and of related records of the management and distribution companies makes it inevitable that he should be relied on as an essential element of the regulatory structure. There are, however, two important limitations on the extent to which he can provide continuing scrutiny of operations. The first is inherent in the nature of his duties. His responsibility is to verify the financial position of the mutual fund at regular intervals, usually annual, and to provide other reports on specified matters at certain times. This means that it would not be feasible to expect him to review each transaction as it occurs. It also means that he cannot be expected to undertake such continuing responsibilities as those of custodian.

6.71 The second limitation on the responsibilities that can be entrusted to the auditor flows from the traditional concept of his function. Auditors are not ordinarily expected to make business judgments. As indicated in paragraphs 6.84 to 6.86, we think there are some cases where auditors can make a contribution through their comments on management's decisions, but we recognize that the circumstances in which an auditor would make such comments are comparatively rare. As a result, it would be a novel extension of an

auditor's responsibilities to require that he make decisions similar to those entrusted to independent trustees in Great Britain or to independent directors in the United States. Unlike independent directors or independent trustees, the auditor does not "second guess" management decisions; he only reports on them.

6.72 In spite of the importance of the two limitations described in the preceding two paragraphs, there is still very considerable scope for the allocation of responsibilities to the auditor. We have been assisted greatly in our consideration of the legislative provisions that would be appropriate to make the most effective use of auditors by the Report of the Special Committee on Shareholders' Audits of the Canadian Institute of Chartered Accountants (referred to for convenience in this section as the "C.I.C.A. Audit Report").* We are in substantial agreement with its recommendations insofar as they are applicable to mutual funds. However, the form of organization of mutual funds is sufficiently different from that of most public companies that changes are necessary to adapt the recommendations in the C.I.C.A. Audit Report to mutual funds. The conclusions we have reached draw heavily on that report; most of them are explained in more detail therein.

6.73 The first question to be resolved with reference to auditors is their method of appointment. At present, the auditors of an incorporated mutual fund are appointed in accordance with the provisions of the applicable corporations act, and those of a trusteed mutual fund in accordance with the procedure specified in the agreement or declaration of trust under which the mutual fund is organized. In each case, this almost invariably means that as a practical matter selection of the auditor is in the hands of the management company. We do not suggest any statutory change in the existing arrangements. Not only have we been unable to devise a feasible alternative method for the appointment of auditors but we believe that the management company would usually be in a position to make a well-informed and good selection.

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* The C.I.C.A. Audit Report was published in <u>Canadian Chartered Accountant</u>, November, 1968.

6.74 While we suggest no change in the procedures whereby auditors are appointed, we think it crucial that they be appointed in all cases. We agree on this with the C.I.C.A. Audit Report, and further agree with that Report that section 122(7) of the Canada Corporations Act provides a feasible precedent for the resolution of any case in which no auditor is appointed. We have concluded that the appropriate administrator should have authority to appoint an auditor in any such case on his own initiative or on application by any shareholder or unitholder. If the relevant legislation is administered provincially, we assume that the administrators will act together in order to avoid any possibility that a mutual fund might have more than one auditor.

6.75 While we make no suggestions for changes in the procedures on appointment of auditors, we have concluded that restrictions should be imposed as to who may be appointed. We agree with the following extract from the C.I.C.A. Audit Report on the important question of independence of the auditor:

> Of greatest importance in the conduct of a shareholders' audit is the auditor's independence. Independence has been defined as a state of mind and as such it cannot be positively assured either through legislation or by the application of rules of professional conduct. Its presence and its appearance can, however, be strengthened by setting out rules for auditors to abide by.

Our specific suggestions as to the statutory requirement for an auditor's independence differ from the recommendations made in the C.I.C.A. Audit Report because of the form of organization of the mutual fund and because we feel that certain factors should be taken into account that are not reflected in the C.I.C.A. recommendations.

6.76 We have concluded that the independence requirement applicable to a mutual fund auditor should be so tailored as to take cognizance of the relationship between mutual fund, management company and distribution company. We would not think it prejudicial to the independence of a mutual fund auditor for him to hold shares or units of the mutual fund; we would think it prejudicial for him to hold shares or units of the management company or the distribution company. On the other hand, we regard it as equally prejudicial for the auditor to be an officer, director or employee of the mutual fund, the management company or the distribution company.

6.77 There is another possibility which should be taken into account in requirements concerning the independence of auditors and which is not specifically reflected by the recommendations made in the C.I.C.A. Audit Report. This is that there might be a relationship between the auditor and the mutual fund or those associated with it that takes the form of a position as officer, director or employee rather than as shareholder. On the latter point, our suggestion is similar to the relevant portion of section 157 of the draft Business Corporations Act being circulated for comment in Ontario.* In addition, our specific proposals give greater recognition to the fact that most auditors practice as members of firms. The test for independence upon which we have decided is set out as recommendation (3) in paragraph 6.88; we have concluded that appointment or continuance as an auditor of a person or firm who or which does not satisfy the suggested test of independence should be prohibited.

6.78 We recognize the possibility noted in the C.I.C.A. Audit Report that the test of independence could be violated without voluntary action on the part of the auditor or anybody associated with the auditor, for example through inheritance of shares. To allow for such instances, we have concluded that in cases where the relationship does not arise solely as a result of an action taken by the auditor or a person or company considered together with the auditor in the determination of independence, a period of six months should be allowed to satisfy the statutory test. We also agree with the transitional provision in the draft Business Corporations Act (Ontario), (subsection 157(4)) which deals with cases where an auditor or a person associated with the auditor owns shares at the time the legislation becomes effective that would disqualify the auditor from acting as such. In such cases, two years would be allowed for

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* Subsection 1 of Section 157 of that draft Act (Bill 125, 25th Legislature, Ontario) deals with the auditor's position as officer, director or employee. It reads as follows:

> No person shall be appointed or act as auditor of a corporation who is a director, officer or employee of the corporation or of an affiliate of the corporation or who is a partner, employer or employee of any such director, officer or employee or who is a related person to any director or officer of the corporation or of an affiliate of the corporation.

"Affiliate" as used in this subsection has the same meaning as in the insider trading provisions referred to in paragraph 9.57.

disposal of the shares provided that disclosure is made in any reports to shareholders or unitholders in the interim.

6.79 The C.I.C.A. Audit Report contains recommendations as to the professional qualifications of auditors. We do not consider that it falls within our purview to determine the appropriate professional qualifications of auditors, and therefore make no recommendations on this question. We do think there should be facility for the dismissal of an auditor who is found not to possess the requisite professional ability. In addition, we have concluded that allowance should be made for situations in which the auditor is not genuinely independent of the mutual fund, management company or distribution company although the statutory test of independence is satisfied. We have therefore concluded that the appropriate administrator should have power, after notice and hearing, to declare that a person or firm is not properly qualified to act as auditor for a particular mutual fund, or for any mutual fund; or to declare that a person or firm is not independent of a particular mutual fund and therefore may not act as auditor on its behalf.

6.80 The prime responsibility of a mutual fund auditor should, we feel, be to its shareholders or unitholders. This is of even greater importance in the context of mutual funds than of commercial companies. We have concluded that this responsibility is appropriately recognized by a requirement that auditors' reports be addressed to the shareholders or unitholders, as well as to the directors or other appropriate authority. This will serve to emphasize the fact that in his review of the mutual fund accounts the auditor acts as a surrogate on behalf of the shareholders or unitholders.

6.81 We have considered whether the auditor should be required to review and to report on financial statements sent to shareholders or unitholders other than those included in the annual report and the prospectus. Cost considerations have led us to decide against such a recommendation, for the expense involved in a requirement that auditors review and report on the financial statements in interim reports would be very considerable. We have therefore concluded that the only financial statements of the mutual fund sent to shareholders or unitholders with respect to which the auditor should be required to

report are those included in the annual report and prospectus; we conclude in Chapter XV that the financial statements in the two documents should be identical.

6.82 We are in almost complete agreement with the portions of the C.I.C.A. Audit Report which consider the content of the auditors' report and the procedures to be followed in its preparation. The reasons for the recommendations are readily apparent, and a discussion is contained in that Report. We therefore here only summarize the relevant recommendations, and adopt them as our own. The relevant legislation (or, preferably, regulations thereunder in order to facilitate amendments) should require that the auditor state whether in his opinion the financial statements covered by the report present fairly the financial position of the mutual fund and the results of its operations and the changes in its net assets for the period under review in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year. The auditor should be required to make such an examination as will enable him to express this opinion.

6.83 The relevant legislation or regulations should specify the applicable alternatives if the auditor is unable to make a report to the effect suggested in the preceding paragraph. The C.I.C.A. Audit Report discusses this question, and we again concur with its conclusion. Three situations are distinguished: (a) where the auditor is unable to form an opinion as to the financial statements; (b) where he forms the opinion that the financial statements do not fairly present the required information (an adverse opinion); and (c) where he forms an opinion in accordance with the required terminology of the report, but subject to certain qualifications. Only in situation (a) should the auditor be permitted to deny an opinion, and in that situation he should state his reasons for the denial. In situations (b) and (c), an opinion should always be presented, with appropriate qualifications and restrictions. Where practicable, opinions in situations (b) and (c) should include an indication of the effect on the financial statements of the qualifications and restrictions made. A "piecemeal" opinion, referring only to certain portions of the financial statements, is appropriate only in situations (a) and (b). These

requirements will be sufficient to cause auditors to conduct a complete review of the affairs of the mutual fund, particularly where problems appear to be present.

6.84 There are many aspects of mutual fund procedures that could affect shareholders or unitholders but which are not reflected in the financial statements and hence are not dealt with by the auditor's report. It is reasonable to expect an auditor to be familiar with mutual fund procedures, and with applicable legislation. In the course of his review, he might encounter evidence of situations that he regards as improper but which do not affect his report. The C.I.C.A. Audit Report comments on this type of situation as follows:

> Improper acts, which are not illegal, might be considered inefficient, commercially unwise or imprudent, in the light of the standards developed by the auditor's professional training and experience. It seems clear that the auditor, when employed to perform a statutory audit, has no legal obligation to concern himself with such improper acts except to the extent that their effects may require disclosure in the financial statements. Cumulative results of such improper acts will be reflected in the company's profits, or lack of them, and it is on this evidence that the readers will form their judgment.
>
> The Committee considered whether or not it would be appropriate to suggest that a statutory duty be laid upon auditors to report either illegal or improper actions to a government authority. It came to the conclusion that in such matters the auditor's position is a particularly delicate one. While maintaining independence it is important that he be assured the confidence of company officials. If to his present duties is added that of informer, his position would be made much more difficult since company officers and employees would tend to withhold information instead of volunteering it. This would be particularly true when there was any possibility that the information might result in a report being made under such a statutory informing provision.

For the reasons indicated by the quotation, the Report recommends against adoption of a requirement akin to section 156(2)(c) of the Companies Act (Saskatchewan) which requires that the auditor report whether in his opinion all the transactions of the company that have come to his notice have been within the objects and powers of the company.

6.85 We do not find the arguments contained in the quotation from the C.I.C.A. Audit Report set out in the preceding paragraph to be convincing with respect to mutual funds. While the auditor cannot be expected to arrive at legal opinions or to review all aspects of mutual fund operations to

express an opinion that legal requirements are being complied with, we think it possible that in the course of his required review situations or practices will come to his attention which he considers to constitute evidence of violations of law or of otherwise improper practices. As the only "outsider" to make such a review, we think it important that the auditor's comments on such matters be reported to the appropriate authority. We have considered whether the report on these matters should be required to be included in the auditor's report on the financial statements, and have decided not to recommend a general requirement to this effect. We have concluded that references to such matters should be included in the report on the financial statements only when they may materially affect the financial information included therein or when the auditor regards the situation as sufficiently serious that he should report it to shareholders or unitholders. No particular provision is necessary for cases in the former category; the legislation or regulations should specifically provide for the latter category, through a statement that the auditor may, but need not, include references in his report to matters that he regards as evidence of illegal or otherwise improper practices although they do not materially affect the financial statements reported on.

6.86 The provision that the auditor may include references to evidence of improprieties in his report should be supplemented by an obligation on the auditor to make a report directly to the appropriate administrator concerning any matter which has come to his notice that he thinks does or may constitute evidence of a violation of law. He should be permitted, although not required, to include in that report a reference to any matter that he believes may constitute evidence of an impropriety, although not an illegality. A copy of the report would ordinarily be provided as a matter of business practice to the management company and to the board of directors (if any) of the mutual fund; a requirement to that effect is unnecessary.

6.87 The nature of our conclusions expressed above is such as to place on the auditor great responsibility in the preparation of his report. It is essential, in our opinion, that management not be able readily to dismiss the appointed auditor, for this could be detrimental to his independence and might

prevent important information from being published. On the other hand, it is important that it be possible to dismiss the auditor; inefficiency or unreasonably high fees are only two good reasons. We have concluded that this problem can be resolved through the adaptation of another recommendation contained in the C.I.C.A. Audit Report. The board of directors or other body which appoints the auditor should also have power to dismiss and replace him without penalty, but the relevant legislation should specify that prior to the dismissal the auditor shall be given not less than fourteen days' notice within which to prepare, if he sees fit, a letter for distribution to the appropriate administrator and to all shareholders or unitholders. The appropriate administrator could then, in his discretion, order that the auditor be retained in office unless approval of his dismissal was obtained from the holders of outstanding shares or units, in accordance with the procedure contemplated by paragraph 6.57. This arrangement would, we believe, adequately reconcile the ability to dismiss auditors with review by interested administrators and shareholders or unitholders.

6.88 For the reasons set out in this section, we recommend:

(1) that, subject to the following recommendations, there should be no change required by statute in the existing requirements and procedures for the election or appointment of mutual fund auditors;

(2) that the appropriate administrator should have authority on application by a shareholder or unitholder or on his own initiative, to appoint an auditor for any mutual fund with respect to which there is no duly qualified auditor currently in office;

(3) that, subject to the following, no person or firm should be appointed or continued in office as auditor of a mutual fund if and so long as any of the following relationships exist; throughout, the term "associate" has the meaning described in paragraph 9.32, recommendation (2), and should not have the extended meaning under paragraph 12.74, recommendation (3)(b), which is designed only to deal with relationships between mutual funds and their portfolio companies:

(a) a partner or professional employee of the person or firm, or a person or company associated with any of them, owns securities issued by the management company or the distribution company of the mutual fund, or by any company associated with the management or the distribution company, other than the mutual fund itself; or

(b) a partner or professional employee of the person or firm, or a person or company associated with any of them, is a director, officer, or employee of the management company, or the distribution company of the mutual fund, or of the mutual fund, or is a person or company associated with the management company, the distribution company or the mutual fund.

When either of the defined relationships occurs, except as a result of a deliberate act by the auditor or a person or company considered together with the auditor in the defined relationships, the recommended prohibition should not become operative unless the relationship continues to exist six months later; and if the relationship in clause (a) exists when the legislation becomes effective, the prohibition should not become operative for two years, but full disclosure should be included in all reports made by the auditor on financial statements of the mutual fund during the two years;

(4) that the appropriate administrator should have power, after notice and hearing, to declare that a person or firm

(a) is not qualified to act as auditor on behalf of a particular mutual fund or, alternatively, on behalf of any mutual fund, or

(b) notwithstanding that the test of independence set out in recommendation (3) is satisfied, is not independent of a particular mutual fund or its management company or distribution company and is therefore not qualified to act as auditor of such mutual fund;

(5) that an auditor's report should accompany the financial statements of the mutual fund that are included in the annual report and the prospectus, and that such report should be addressed to the shareholders or unitholders as well as to the board of directors or other appropriate authority;

(6) that, subject to the following recommendations, the auditor's report referred to in recommendation (5) should state whether in his opinion the financial statements covered by the report present fairly the financial position of the mutual fund and the results of its operations and the changes in its net assets for the period under review in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year;

(7) that the auditor should be required to make such an examination as will enable him to express the opinion referred to in recommendation (6);

(8) that it should be permissible to omit the opinion referred to in recommendation (6) if the auditor cannot form an opinion on the financial statements, but in such event, the auditor should state the reasons why he is unable to form an opinion;

(9) that if the auditor determines either

(a) that the financial statements do not present fairly the financial position of the mutual fund or otherwise satisfy the criteria of the form of opinion set out in recommendation (6); or

(b) that he can express an opinion in the form set out in recommendation (1) but with certain qualifications,

then he should express an opinion with such restrictions and qualifications as he feels appropriate; where practicable, he should indicate the effect on the financial statements of the restrictions and qualifications;

(10) that a "piecemeal" opinion should be rendered only in cases contemplated by recommendation (8) or recommendation (9), clause (a);

(11) that the auditor should be permitted, but not required, to include in the report referred to in recommendation (5) a reference to any matters which have come to his notice that, in his opinion, constitute evidence of violations of law or are otherwise improper, although they do not materially affect the financial statements;

(12) that the auditor should be required to report to the appropriate administrator any matters which come to his notice that, in his opinion, do or might constitute evidence of violations of law, and should be permitted so to report any evidence of matters that he regards as improper; and

(13) that the board of directors or other body which appoints the auditor should also have the power to dismiss and replace him without penalty, but should first give him at least fourteen days' notice during which he may prepare a letter that should forthwith be distributed to the appropriate administrator and to shareholders or unitholders; after receipt of that letter, the appropriate administrator could require that the auditor be retained in office unless the consent to the dismissal of the holders of outstanding shares or units was obtained in accordance with the procedure referred to in paragraph 6.59, recommendation (3).

Internalization of the Management and Sales Functions

6.89 The comment is sometimes made that many of the problems of the mutual fund industry are attributable to the separation from the mutual fund of the management and sales functions, and could be resolved if they were performed by the mutual fund itself through its employees. The need for scrutiny of management is only one of the problems that, it is said, would be resolved by compulsory internalization of the management and sales functions, but it is convenient to discuss the proposed solution here. It should be emphasized that the question is whether these functions should be required to be internalized; we have taken cognizance in the formulation of all our recommendations of the desirability that the formation of internalized mutual funds not be impeded. The only significant restriction we recommend on such a mutual fund is that, for reasons indicated in paragraph 13.23, it should not be permitted to pay the costs involved in the distribution of its shares or units.

6.90 It is of importance that management and distribution companies are not ordinarily conducted as separate operations from the mutual fund; all are part of the same organization. The separation of functions is not designed

to insulate the management and distribution companies from the mutual fund. Rather, as explained in paragraphs 1.04 to 1.08, it permits the organizers to obtain an entrepreneurial reward from their efforts. If the instrument issued by a mutual fund were a debt instrument carrying a fixed rate of return, the management and distribution functions would probably be internalized as they are in financial institutions which issue that type of instrument. For this reason, we doubt that internalized mutual funds will ever become a significant development without governmental compulsion.

6.91 For the same reason, we doubt that compulsory internalization would attain beneficial results, and we even more strongly doubt that any beneficial results attained would be of sufficient value to justify the confusion and problems that would be attendant on application of the requirement. The organizers of a mutual fund are just as intimately involved with it as they would be if it carried on its own management and sales activities, and the separation of ownership from management would be equally pronounced in the latter case. We can see no logical reason to assume that the need for continuing scrutiny of management would be any less or any greater if these functions were internalized. A salaried employee who is not subjected to continuing scrutiny is at least as susceptible to conflicts of interests as an outside organization compensated on a fee basis and not subjected to continuing scrutiny. It is the separation of ownership from management which causes any problems that exist, not the segregation of functions.

6.92 As indicated above, other arguments than that relating to scrutiny of management are advanced to support compulsory internalization of the management and sales functions. Perhaps the most important such argument relates to costs. The claim that costs would be reduced by internalization rests on the assumption that persons compensated by salary will probably receive less than they would if compensated on a fee basis. This argument seems to us to relate principally to management fees paid by the mutual fund rather than to sales charges paid by the purchaser of shares or units in the mutual fund, for we can see no reason why internalization of functions should have any effect on sales charges. Thus confined, the argument may have some merit with the larger

mutual funds; we do not think it necessary to reach a conclusion on this point, for we believe that implementation of our recommendations on management fees in Chapter X would prevent serious abuses from arising in the area of management fees charged by the larger mutual funds. With smaller mutual funds, we do not agree that internalization of functions would result in reduction of management costs. Very few small mutual funds could afford to hire sophisticated persons on a full-time basis; many of their management companies presently do not make a profit on this work, and provide the service in the hope that there will be a long-term growth in assets of the mutual fund with a commensurate increase in the amount of the management fee.

6.93 In paragraphs 1.11 to 1.16 we make reference to mutual funds as part of Canadian financial complexes. The importance of such complexes has increased markedly in recent years, and those who take a serious view of this question might favour compulsory internalization on the theory that a mutual fund which handled its own investment management and distributed its shares or units to the public on its own behalf would be less likely to form part of a financial complex. We do not feel that it lies within the scope of our responsibility to recommend restrictions on mutual funds solely in order to prevent them from forming part of financial complexes. Quite apart from this, even if we did agree that recommendations dictated by these factors fell within our purview we doubt that compulsory internalization of functions would be a desirable or even a feasible method of dealing with the relationships between mutual funds and financial complexes.

6.94 We state above our belief that confusion and problems would be attendant on the introduction of a compulsory internalization policy, to the point that they would outweigh the benefit of any favourable results obtained. Only a few examples need be cited to establish this. Many management companies, particularly those associated with mutual funds whose shares or units are sold through direct sales forces, have management contracts with several mutual funds. Many more regard mutual fund management as a minor aspect of their activities, and would not be prepared to merge with the managed mutual fund or to cause the persons responsible for advising it to become its

employees. In several cases, particularly with the larger companies, the management company is a public company with shareholders different from the managed mutual fund. It is apparent that compulsory internalization would be difficult in all these situations, and might be impossible in some. Yet these represent only a few of the many problems which would be encountered in the implementation of such an approach.

6.95 For the reasons set out in this section, we have concluded that no attempt should be made to require compulsory internalization of the management and sales functions in the Canadian mutual fund industry.

CHAPTER VII

ADMISSION TO THE INDUSTRY; MINIMUM CAPITAL REQUIREMENTS

7.01 Chapter VI is devoted to a consideration of the relationship between shareholders or unitholders of a mutual fund and those responsible for its management. Particular attention is given to methods by which continuing independent scrutiny might be provided over the operations of mutual funds, other than by governmental agencies. The purpose of such scrutiny would be to guard against risks of the types discussed in paragraphs 6.04 to 6.09. While implementation of the recommendations made in Chapter VI would, we believe, contribute significantly to the quality of investor protection, none of those recommendations would provide the continuing scrutiny which we think desirable. It is therefore necessary to consider in detail what legislative requirements would provide adequate protection against the types of risk that might otherwise be dealt with through continuing independent scrutiny of management.

7.02 The discussion in paragraphs 6.04 to 6.09 is premised on our assumption that the only risks the mutual fund investor would be prepared, or should be expected, to accept are those attributable to investment decisions which prove to be mistaken although made in good faith. The other risks discussed in those paragraphs do not fall within this category, and appropriate procedures or requirements should be established to reduce or eliminate the degree of exposure to these risks. All are attributable either to the possibility of dishonesty or bad faith on the part of persons concerned with the operation of the mutual fund, or to the possibility that financial difficulties might be encountered for reasons other than dishonesty or bad faith, or mistaken investment decisions made in good faith.

7.03 It is apparent that the exposure to risks of the type described in the preceding paragraph could be reduced or eliminated if participation in the mutual fund industry were restricted to honest and ethical men of good financial standing and ability. No slur on the mutual fund industry is intended in our belief that it would be unreasonable to assume that all its participants satisfy that standard, or will do so in the future. In this chapter, we consider to what extent requirements should be imposed on entrants to the industry in an attempt to approach the standard.

7.04 No objective criterion has yet been devised which can be relied upon invariably to distinguish persons who are completely honest and financially stable from those who are not. This does not mean that no effort should be made to exclude undesirable persons from the mutual fund industry. Registration requirements now in effect are used by securities administrators to exclude persons who seem undesirable. A variety of criteria are applied in that determination, of which the most important are requirements for specified minimum amounts of free capital in the form of equity or subordinated debt, and personal assessments based on character references and similar information. In addition, nine of the ten provinces require salesmen to take a training course as a precondition to full registration. We can offer no major improvements on these techniques, although we propose a number of changes in the details of the rules which are applied.

7.05 Much of the discussion in this chapter concerns minimum capital requirements. Such requirements serve two principal objectives. First, they ensure that the organizations concerned have some equity capital available to act as a cushion in the event of financial difficulties. Perhaps of even more importance, they assist to restrict participation in the industry to persons who are prepared to make a relatively substantial monetary contribution and thereby to show that they feel a long-term commitment. Fly-by-night operators are even more dangerous in the securities industry than in most other walks of life. Ideally, the amount of free capital required should be such as to satisfy these objectives without unduly restricting admittance to the industry. It is apparent that the precise amounts appropriate for these purposes will change

with the economy and with industry practices. We therefore attach more importance to the reasoning by which dollar figures are arrived at than to the figures themselves. In keeping with our responsibilities we make specific proposals for dollar figures, but we hope that these proposals will be implemented by regulation rather than legislation and will be kept under constant review.

7.06 While the minimum capital requirements set out in this chapter are relatively precise, our proposals would leave a considerable amount of discretion with the administrator in other aspects of the decision as to whether to accept applications for registration. Unless and until objective tests can be formulated which can be relied upon to determine with precision the honesty and financial stability of an applicant, we consider this type of discretion to be both necessary and desirable. Minimum capital requirements cannot alone be sufficient for the effective exclusion of undesirable persons.

7.07 The fact that registration requirements cannot be relied upon to restrict entrance to the industry to persons who are completely honest and financially stable necessitates consideration of other techniques to avoid the risks with which we are here concerned. These are discussed in Chapters VIII and IX. Chapter VIII considers requirements designed to enforce adherence to adequate standards for the custody of assets in the industry. Chapter IX deals with the specific and difficult problem of regulations designed to avoid unfavourable consequences from conflicts of interest. In the following sections of this chapter we first discuss registration requirements and then the minimum capital and related provisions which should be applied to various organizations as registrants. Registrants who are concerned with the sale of contractual plans are separately considered for we have concluded that they should be subject to more rigorous requirements. We then consider the registration and training of individuals, and finally the consequences which should follow from failure to satisfy the various requirements proposed in the chapter.

Registration Requirements for Organizations

7.08 One of the principal themes which pervades this report is that the mutual fund, its management company and its distribution company should be treated as a single organization for regulatory purposes although they are

technically separate entities. The reasons for the separation from the mutual fund of the management and distribution functions, set out in paragraphs 1.04 to 1.07, arise from the fact that this arrangement best facilitates the collection by mutual fund organizers of their entrepreneurial reward. The adoption for that purpose of a particular organizational arrangement should not affect the nature of the regulatory requirements to which the organization is subject, yet it presently does so. Another problem is that, if the shares or units of a mutual fund are being distributed to the public the mutual fund must maintain a prospectus on file in each province where the distribution is being carried on. In addition, those engaged in the distribution must be registered with the appropriate securities administrators. Yet if no distribution is in progress, no prospectus filing and no registration requirements are applicable. Even if a distribution is in progress, the management company need not register if it is a separate entity from the distribution company; at December 31, 1967, this was true of 27 of the 84 management companies of mutual funds qualified for sale in Canada.

7.09 The filing and registration requirements presently applied under Canadian securities legislation are designed to facilitate controls over the sale to the public of securities. In this report, we recommend a number of requirements for application to mutual funds which go beyond the procedures followed on the sale of their securities. As financial institutions to which members of the public confide their savings dollars, controls over mutual funds applied for the protection of the investor should not be dependent upon whether their shares or units are currently in the course of public distribution. Nor should the management company be immune from regulations because it is a separate entity from the distribution company. We have therefore concluded that if a mutual fund is operating within the relevant jurisdiction at the effective date of the legislation, or thereafter commences to operate in that jurisdiction, that mutual fund, its management company and its distribution company should all be required to become registered with the appropriate administrator. Registration should continue while the mutual fund continues to operate within the jurisdiction. Registration of individuals connected with the three organizations is discussed in paragraphs 7.55 to 7.59.

7.10 The key phrase in the conclusion set out in the preceding paragraphs is "operating within the relevant jurisdiction". The relevant jurisdiction if legislation which implements our recommendations is nationally administered should be Canada; the relevant jurisdictions if such legislation is provincially administered should be each province of Canada. As indicated in the preceding paragraph, the registration requirement ought not to be dependent on whether shares or units of the mutual fund are currently being sold to the public within the jurisdiction. We have therefore concluded that a mutual fund should be considered to commence operations in a jurisdiction when its shares or units are first sold to the public within that jurisdiction. It would continue to operate therein until the time when: (i) its shares or units were no longer being sold to the public within that jurisdiction and (ii) it had less than twenty shareholders or unitholders of record whose last known addresses were within the jurisdiction. For convenience in the application of the requirements it should be assumed that if the shares or units of a mutual fund are qualified for sale to the public in a jurisdiction, they are in fact being so sold. These conclusions are, of course, subject to those in Chapter V, under which an organization would not ordinarily become a mutual fund until it had in excess of fifty shareholders; these would include all such holders, wherever located.

7.11 An obvious question which arises from the meaning we propose for "operating within the relevant jurisdiction" is in the application of that phrase to mutual funds organized outside Canada. It is, in our view, clear that when the distribution company of such a mutual fund actively solicits orders for its shares or units within Canada, the mutual fund and its management and distribution company should be subject to the registration requirements; the regulations proposed in this report would also all apply to it, except to the extent that they were modified by the administrator pursuant to the proposals concerning regulation of foreign mutual funds in paragraphs 16.58 to 16.69. The real problems arise with the cases in which Canadians seek out a foreign mutual fund for investment. As noted in paragraph 16.61 we have reason to assume that this has in recent years occurred with some frequency in the context of United States mutual funds.

7.12 Opinions on the problems stated in the preceding paragraph range through a wide spectrum. At the one extreme, it could be said that any mutual fund which accepts orders from Canadians should be subject to the Canadian regulatory requirements to the extent that Canada and its provinces have authority to enforce them; as a corollary, Canadian brokers should be prohibited from accepting orders for the purchase of shares or units issued by foreign mutual funds. At the other extreme, it could be said that a Canadian who is sufficiently knowledgeable to seek out a particular foreign mutual fund without the assistance of a salesman should be able to invest in that mutual fund through a Canadian broker.

7.13 We reject each of the positions described in the preceding paragraph. Realistically, it must be recognized that the Canadian determined to invest in a foreign mutual fund will be able to do so even if he must effect the purchase through a broker or a nominee resident in the foreign country. To prohibit such purchases through Canadian brokers will only put the person who wishes to make such an investment to unnecessary inconvenience. On the other hand, to remove completely the barriers to these instruments might result in serious abuses through the acquisition by Canadians of shares or units issued by unregulated mutual funds in various foreign countries. A compromise is needed.

7.14 In paragraphs 12.75 to 12.90 we consider the investments which should be permitted for Canadian mutual funds organized to invest in shares or units issued by other mutual funds. We there conclude that such mutual funds - referred to by us as "funds on funds" - should be restricted for investment purposes to mutual funds qualified for sale in Canada, and to mutual funds that are subject to regulations applied by other countries which in the opinion of the administrator, provide an equal degree of protection for the investor. We have concluded that the same approach should be applicable to Canadian investors generally. On the analysis set out in Chapter II, this will mean that access to foreign mutual funds will effectively be restricted to purchasers for whom they are shopping goods, but that even such purchasers

will find it very difficult to invest in a mutual fund which is not itself subject to an adequate regulatory scheme.

7.15 To implement the conclusion reached in the preceding paragraph, the relevant legislation should specify that a foreign mutual fund subject to regulations which the appropriate administrator recognizes under the proposals in paragraph 12.88 to provide adequate investor protection would not become subject to the Canadian registration requirements merely as a result of unsolicited sales effected through Canadian brokers. Canadian brokers should be permitted to accept orders for such sales, provided that they are not solicited in any way.

7.16 Foreign mutual funds with respect to which no order is made as contemplated by paragraph 12.88 should not be exempted in the manner described in the preceding paragraph, and Canadian brokers should be prohibited from the acceptance from Canadians of orders for the purchase of shares or units issued by such mutual funds; for this purpose, "Canadian brokers" would include any person or organization registered as a broker in Canada. This does not imply that any such mutual fund would become subject to the regulatory scheme when acquired by Canadians; such acquisitions might occur without any offering to the public in Canada, and in any event there are limits to the effective scope of Canadian authority. It does mean that the legislation should discourage investment by Canadians in such mutual funds.

7.17 The preceding discussion relates only to mutual funds, their management companies and their distribution companies. Other organizations participate in the distribution of shares or units, and their registration should also be required. Brokers are required to be registered in any event. Independent sales forces should be registered, as should the contractual plan service companies discussed in paragraphs 7.50 to 7.52. Direct sales forces are operated by distribution companies, and are therefore included in the requirements proposed in preceding paragraphs. Subject to the conclusions set out in Chapter XVI, the registration of other financial institutions engaged in the sale of mutual fund shares or units should be required. Salesman

registration is included in the discussion of the registration of individuals in paragraphs 7.55 to 7.59.

7.18 In many instances, registration requirements will apply to organizations already required to obtain registration in another capacity. Brokers are one example of this. Trust companies are another; those trust companies which operate trust company investment funds would register as management companies, and would also be required to register as distribution companies. Yet all trust companies are registered with Registrars of Trust Companies or corresponding officials in the provinces. If possible, arrangements should be made to avoid such duplication of registration; if it cannot be avoided, requirements should be so arranged as to reduce the formalities involved to a minimum.

7.19 In view of the scope of the registration requirements we propose, we have concluded that the administrator should have broad authority to grant exemptions from those requirements where circumstances make such exemptions appropriate. The power should extend to permit either a complete or a partial exemption; in the latter case, the administrator could specify which of the regulatory requirements that result from registration are to be applicable to the exempted organization. The variety in methods of operation within the industry is so great that this type of power is the only way to provide the necessary degree of flexibility in the application of regulations.

7.20 For the reasons set out in this section, we recommend:

(1) that for purposes of the following recommendations, but subject to recommendation (3), whether a mutual fund is operating within the relevant jurisdiction at the effective date of the legislation should be determined by the following tests:

(a) if the legislation is provincially administered the relevant jurisdictions would be the provinces and a mutual fund would be operating within a province if its shares or units are qualified for sale under the securities legislation of that province at the effective date of the legislation, or if they had previously

been so qualified but sales had ceased and the qualification terminated before that date;

or

(b) if the legislation is nationally administered, the relevant jurisdiction would be Canada and a mutual fund would be operating within Canada at the effective date of the legislation if at that time it was operating within any province of Canada under the test in clause (a);

In either case, a mutual fund should be considered no longer to be operating within the relevant jurisdiction when its shares or units are no longer qualified for sale to the public within that jurisdiction, and it has less than twenty shareholders or unitholders of record whose last known addresses are within the jurisdiction;

(2) that registration under separate categories of registration should be required for:

(a) each mutual fund operating within the relevant jurisdiction at the effective date of the legislation, or which therafter commences to operate there, together with its management company and its distribution company;

(b) subject to the recommendations in Chapter XVI, all other persons or organizations engaged in the distribution or sale to the public of mutual fund shares or units, including other financial institutions; and

(c) contractual plan service companies;

(3) that a mutual fund organized elsewhere than in Canada in which investments are permitted for funds on funds under paragraph 12.91, recommendation (8), should not be considered to operate within the relevant jurisdiction merely because of sales to Canadians made as a result of unsolicited orders placed by such Canadians;

(4) that persons or companies registered as brokers in Canada should be prohibited from the acceptance from Canadians of orders for purchase of shares or units issued by foreign mutual funds, unless such shares

or units are qualified for sale in Canada (or in the relevant province) and except in the circumstances contemplated by recommendation (3);

(5) that in the application of the registration requirements the responsible authorities should make all reasonable efforts to avoid the imposition of duplicate requirements on organizations required to register in another capacity; if duplicate registration cannot be avoided, formalities should be reduced to a minimum; and

(6) that the appropriate administrator should have power to grant a complete exemption from the application of the registration requirements to any person or organization or to grant a partial exemption which would extend only to some of the regulations consequent upon registration; in either event, the exemption could be made subject to compliance with such conditions as the administrator thought fit.

<u>Minimum Capital Requirements for Registrant Organizations; Registration Procedures</u>

7.21 Our belief, for the reasons indicated in paragraph 7.05, that minimum capital requirements should be included among the criteria applied to entrants to the mutual fund industry, is far from novel. Such requirements almost invariably form part of the regulatory scheme applied to financial institutions, and have long been applied in Canada by securities administrators through the exercise of their discretionary authority. Early in 1969 the Ontario Securities Commission published a statement of policy* which sets out in greater detail than had previously been available in Canada the guidelines and requirements to be adhered to by participants in the securities industry. The statement of policy applies to mutual fund distribution companies, but for the most part treats them together with other types of registrant. While the statement constitutes a helpful articulation of policy in this area, we have concluded that it would be desirable for the relevant requirements to be more

* Ontario Securities Commission, Policy Statement on Conditions of Registration, February 17, 1969, as subsequently amended.

specifically formulated for the mutual fund industry. To the extent that our conclusions in this and the following sections deviate from the statement of policy, the explanation is largely to be found in characteristics of mutual funds that are not present in other aspects of the securities industry.

7.22 Paragraphs 7.45 to 7.54 contain a separate discussion of mutual funds the shares or units of which are sold through contractual plans, and of independent sales forces and brokers which sponsor contractual plans. The proposals made in the following paragraphs are intended to apply to such organizations in addition to those made in paragraphs 7.45 to 7.54. Contractual plan service companies are not dealt with in this section. With these exceptions, the conclusions reached in this section are intended to apply to all organizations that would be required to register under proposals made in the preceding section, but should not be treated as additions to requirements presently in effect. Brokers and trust companies, for example, are subject to minimum capital requirements; they should also be subject to the requirements proposed by us only if and to the extent that our proposals are more rigorous.

7.23 The two objectives referred to in paragraph 7.05 of minimum capital requirements are to provide an equity cushion against financial losses and to ensure that entrants feel a sense of long-term commitment to the industry. It is important that the requirements be formulated in such a way as to attain both these objectives. This is particularly relevant with respect to the mutual fund itself. Securities administrators of several provinces presently impose minimum capital requirements on newly qualifying mutual funds which are similar in principle although the dollar amounts involved vary considerably. They require an initial investment of between $100,000 and $250,000 which must be included in the assets of the mutual fund before they will accept its prospectus for filing. The shares or units that represent this initial investment may not be presented for redemption until the total net assets of the mutual fund reach a certain minimum level, usually about $250,000, and redemptions of such shares or units may then be effected only if and to the

extent that this is possible without reducing total net assets below the specified level.

7.24 The requirement for initial capital of mutual funds described in the preceding paragraph is of value to provide an equity cushion in case of financial difficulties, but in our view it should be supplemented by further provisions if a sense of long-term commitment on the part of mutual fund organizers is to be encouraged. It could be said that by the time a mutual fund has reached $250,000 in total net assets the management contract is of sufficient value to accomplish this objective, for the organizers would not wish to sacrifice it. We are not prepared to accept this approach; we think it necessary that the mutual fund organizers or management company have a direct financial interest in the mutual fund. That this is a question upon which different opinions are possible is indicated by the fact that the Investment Company Act of 1940 contains no requirement for continuing investment by mutual fund management, while in the Republic of South Africa the management company, unless it obtains an exemption, must "of its own resources have at all times invested in every unit portfolio an amount equal to at least ten per centum of the value of the underlying securities in such unit portfolio, and shall hold the units in respect of such investment as beneficial owner".* The provisions of the South African legislation are, in our opinion, unduly rigorous for application in the Canadian situation, but they provide a valuable example of the importance attached to this type of requirement in another jurisdiction.

7.25 We have concluded that a mutual fund should not be permitted to commence operations with total net assets of less than $100,000, and that shares or units representing $50,000 of this amount should be placed in escrow to confirm the continuing commitment of those responsible for the management of the mutual fund. The shares or units representing the other $50,000 of the initial $100,000 could be presented for redemption subsequently, if this redemption would not reduce total net assets below $250,000. These arrangements should be enforced by obtaining a written undertaking when a mutual

* Republic of South Africa: Unit Trusts Control Act, 1947, No. 18 (1947) as amended s.13.

fund is registered with total net assets of less than $300,000. The undertaking, to be given by the holders of shares or units to the value of $50,000 (other than the escrowed shares or units) would state that they would not redeem such shares or units if by so doing total net assets would be reduced below $250,000 and would not transfer them unless the transferee gave a similar undertaking.

7.26 The mechanics of the proposed escrow arrangement would be comparatively simple. No requirement would be necessary as to what persons should provide the shares or units for escrow, since nobody except the organizers or their successors would be prepared to do so; they might elect to have the management company as the beneficial owner of the shares or units escrowed, an arrangement which would be consistent with the objectives of the requirement. The shares or units would be delivered to a trustee acceptable to the appropriate administrator. Even if the legislation to implement our recommendations is administered provincially, only one escrow arrangement would be required. The trustee would be under a statutory obligation not to permit the transfer or redemption of the shares or units without prior consent of the appropriate administrator in each province where the mutual fund was registered. The beneficial owners of the escrowed shares or units would be entitled to receive any dividends which were paid on them, and to exercise all voting rights. These arrangements have ample precedent in similar requirements presently imposed for other purposes by Canadian securities administrators.

7.27 The requirements proposed in the two preceding paragraphs would have a number of advantages. First, the escrow arrangement would effectively enforce compliance with the minimum investment requirement. Second, the requirement that the consent of the appropriate administrator be obtained for transfers of the shares or units would facilitate enforcement of the restrictions on transfers of management and sales contracts proposed in paragraphs 11.16 to 11.26. Third, continuing control over foreign mutual funds registered in Canada would be assisted by the availability in this country of shares or units with an original value of $50,000. Fourth, as noted in paragraph 7.66

the escrowed shares or units could be effectively used as a contribution to the legal and other costs involved if a liquidation of the mutual fund should ever become necessary.

7.28 Certain special provisions are desirable for mutual funds operating within the relevant jurisdiction at the effective date of the legislation. The escrow requirement should not apply to such a mutual fund unless and until its management contract is transferred, a point dealt with in paragraph 11.26. If any such mutual fund at the effective date of the legislation has total net assets of less than $100,000, it should nevertheless be required to register but public distribution of its shares or units should be prohibited unless and until its total net assets increase to $100,000 as a result of private sale of shares or units or otherwise.

7.29 In some ways, the financial position of the management company may be even more important to the investor than that of the mutual fund. With the latter, his concern is primarily for the net asset value per share or unit, and he cares little about changes in total net assets. The management company, on the other hand, must be sufficiently well-financed to provide adequate management advice, for only thus can it properly perform its responsibilities under the management contract. However, it is difficult or impossible to determine an exact amount of money which is needed to perform the management function effectively. A single portfolio manager working on a part-time basis may produce results superior to those of a staff of analysts, if he is gifted with the necessary combination of investment genius and luck.

7.30 Another factor relevant in the determination of minimum capital requirements applicable to the management company is that, as noted in paragraph 7.08, most management companies are also distribution companies; they would, therefore, be subject to the minimum and free capital requirements proposed in the remainder of this section. The question to be resolved is whether additional requirements should be imposed by reason of their management responsibilities. On this question, it is important that the management company will always have one asset of value, and may have two. The right to manage the

mutual fund is usually regarded as a saleable right, and in cases where the management company owns the beneficial interest in the shares or units escrowed to satisfy the requirements proposed above that beneficial interest will also be of value. Finally, it is noteworthy that no serious problems have been occasioned by the present lack of any minimum capital requirement applicable to management companies. For all these reasons, we have concluded that the only financial requirement necessary is that the management company at all times have a net free capital of at least $1 without taking into account the value of the management contract or of the beneficial interest in escrowed shares or units.

7.31 In connection with the requirements we propose for application to distribution companies and other organizations involved in the sale to the public of shares or units issued by mutual funds, it is helpful briefly to summarize the discussion in Chapter II of the various methods used for the sale of shares or units. The distribution company is crucial to all these methods. It has the right, by contract in the case of incorporated mutual funds and pursuant to the trust instrument in the case of unincorporated mutual funds, to distribute shares or units of the mutual fund to the public. It may act either as agent, effecting sales on behalf of the mutual fund, or as principal, purchasing the shares or units from the mutual fund for resale. While the legal relationships are different, the procedures followed are very similar. The distribution company receives the purchase price from the purchaser, makes the appropriate deduction for sales and service charges, and transmits the balance to the mutual fund. It therefore handles all money paid by purchasers. In addition, it usually arranges the issuance of shares or units to purchasers, and in many cases it acts as custodian of shares or units on their behalf, or arranges for a bank or trust company so to act.

7.32 A distribution company may effect sales through any or all of the three principal channels, the direct sales forces, independent sales forces, or brokers. In cases where other financial institutions such as banks or trust companies act as distribution companies or are associated with distribution companies, exclusive or partial reliance may be placed on other channels available to the financial institution; the best examples of this are sales through

the branches of the banks and trust companies. The application of our proposals to other financial institutions is commented on in Chapter XVI and elsewhere in the report; the discussion here is confined to the three principal channels of distribution.

7.33 The most important of the three principal channels in Canada are the direct sales forces. These forces, organized by some distribution companies, are composed of salesmen who are usually treated as being, in law, agents or independent contractors of the distribution company, although they are actually subject to closer control by it than those terms would imply. For reasons indicated in paragraph 10.70, we think it possible that implementation of our recommendations in Chapter X may cause distribution companies to treat direct sales force salesmen as employees. Technical differences in the legal position have little effect on the actual procedures followed by the direct sales force salesmen in their relationships with the distribution company. Individual direct sales force salesmen rarely handle money received from purchasers; they transmit application forms to the distribution company which usually contacts the purchaser directly by mail. Payments received for shares or units are almost invariably in the form of cheques payable to the distribution company or a custodian or trustee. Regardless of the mode of payment, salesmen are not permitted to deduct their compensation; the full purchase price must be paid to the distribution company. Each salesman's compensation is regularly computed and paid to him by the distribution company.

7.34 A brokerage firm which sells mutual fund shares or units, unless it is the distribution company of the mutual fund concerned, does so pursuant to an agreement with the distribution company. Such agreements may be written or oral. Here, again, both the legal relationships established, and the procedures followed differ considerably. The broker may purchase from or through the distribution company for resale as principal, or may act as agent of the distribution company. He may remit to the distribution company the proceeds of sale less his agreed commission; or may remit the full sale price and be credited with commission.

7.35 The third principal channel of distribution is the independent sales force specializing in the sale of mutual fund shares or units. These organizations have relationships with distribution companies similar to those of brokers. Only a few practical differences are present. The independent sales force does not engage in a general securities business, as do most brokers; and in some, but not all, cases the independent sales force does not handle purchasers' money but receives cheques made payable directly to the distribution company or a trustee or custodian.

7.36 With all three of the types of organization discussed in the preceding paragraphs, there is an objective to be attained through capital requirements in addition to the two objectives of providing an equity cushion in case financial difficulties are encountered and of ensuring long-term commitment to the industry. This additional objective is to guard against the loss of money paid by the purchaser before it is added to the assets of the mutual fund. The procedures followed on the handling of money received differ between organizations. The distribution company, directly or through a custodian or other agent, in all cases takes in the money and transmits the balance after deduction of sales and service charges to the mutual fund. Where the sales are made by or through a broker or independent sales force, the money is in most cases received by the broker or independent sales force and transmitted to the distribution company; less frequently, it is paid directly to the distribution company.

7.37 There is an obvious temptation for all distribution companies, and for those brokers or independent sales forces which handle purchasers' money, to postpone transmission of the money for a short period in order to make use of it for their own purposes, or at least to obtain the benefit of interest earned on it. Any such practice is detrimental to the mutual fund and its participants, and should be prohibited. No organization engaged in the sale of mutual fund shares or units should be permitted to have the use of purchasers' money, or to receive the interest on that money, for any period of time. We have therefore concluded that appropriate provision should be made to ensure that money received for the purchase of mutual fund shares or units is not

used for any purpose other than investment in the mutual fund, and that interest earned during any period of delay pending such investment should accrue to the benefit of the mutual fund. Ideally, the interest should be credited to the account of the purchaser whose money earned it; that would, however, cause serious administrative difficulties and we have concluded that it should not be a requirement. It should be permissible merely to add the interest to the mutual fund for the benefit of all participants.

7.38 The Ontario Securities Commission and some other provincial securities commissions presently apply a policy ruling* which prohibits organizations subject to it that are engaged in the distribution of mutual fund shares or units from commingling money received for mutual fund shares or units with their other assets. The ruling effectively prevents the use of such money for other purposes; it does not, however, deal with the question of interest. We have concluded that it should be amended to do so, in accordance with the suggestions made in the preceding paragraph. In addition, we have concluded that the ruling should be amended by the deletion of exemptions in favour of organizations, particularly brokers, which are subject to the authority of a self-regulatory association. Some of the self-regulatory associations concerned, such as the Investment Dealers Association, have no similar requirements since such requirements are not appropriate for transactions in the secondary markets. Members of these self-regulatory associations are therefore not prohibited from making use of money paid for shares or units during the period prior to its payment to the mutual fund, nor from retaining interest earned on such money during that period. We believe that they should be subject to the same restrictions on these practices that are applied to other organizations. Finally, the policy ruling should be amended to require that money received for the purchase of shares or units must be transmitted to the mutual fund as expeditiously as reasonably possible following the determination of the price of the shares or units purchased.

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* Bulletin of Ontario Securities Commission, July-August 1966, p. 3-5 as amended by Bulletin of Ontario Securities Commission, December, 1967, p. 84-85 and March, 1968, p. 31-34.

7.39 Requirements to the effect proposed in the preceding paragraph, supported as they are under the Ontario Securities Commission policy ruling by a requirement that auditor's reports be made annually to the appropriate administrator to establish compliance, adequately resolve what would otherwise be a major problem in the formulation of capital requirements for distribution companies and other organizations engaged in the sale of shares or units. Additional provisions are, however, needed for the adequate protection of the investor. The cost of creation of a sales organization, particularly a direct sales force, can be substantial. An inadequately financed organization that is not initially successful may collapse with consequent inconvenience and potential financial loss to its salesmen, to its clients and to the mutual fund with which it is associated. We have concluded that minimum capital requirements in addition to the prohibition against commingling should be imposed on all such organizations.

7.40 An obvious problem arises in the formulation of minimum capital and solvency requirements by reason of the great variety in sizes of the organizations concerned. Any rule should be so formulated as to be workable in its application to organizations of any size. The Ontario Securities Commission policy ruling referred to in paragraph 7.21 resolves this problem through the imposition of a minimum capital requirement in an amount equal to the greater of a specified number of dollars or a specified percentage of adjusted liabilities, as therein defined. We have concluded that this is the most satisfactory approach. The specified dollar figure, as the minimum investment, requires a financial commitment from the organizers of a smaller enterprise which is sufficient to ensure their long-term commitment to the industry. The percentage of adjusted liabilities, which becomes operative as the minimum investment for larger organizations, constitutes a constraint against the acceptance of obligations they are unable to implement, and also ensures an adequate cushion of equity investment as the organization grows.

7.41 While we accept the principle of the Ontario Securities Commission policy ruling, we propose certain changes in details. Those which relate to the distribution of contractual plans are discussed in paragraphs

7.45 to 7.54. Others are attributable to the fact that we believe distribution and sales organizations which regularly handle money received from the purchaser, even subject to the commingling prohibition, should be subject to more rigorous requirements than those which do not. Distribution companies must ordinarily handle money received from the purchaser, except that if no sales charges or service fees are to be deducted it might be possible to arrange for payment to be made directly to the mutual fund. With other sales organizations it is comparatively easy to arrange for purchasers to pay directly to the distribution company, which in turn can compensate the sales organization for its commission. This procedure provides an element of protection for the investor that is not available even with the prohibition against commingling.

7.42 The Ontario Securities Commission policy ruling requires that all organizations which are subject to it must maintain minimum net free capital at all times equal to $25,000 or to 10% of adjusted liabilities, as therein defined, whichever is greater. We have concluded that this rule is appropriate for distribution companies, brokers and independent sales forces which handle money received from purchasers, albeit subject to the prohibition against commingling. A broker or independent sales force which made arrangements for substantially all money paid by purchasers to be paid directly to the distribution company or its custodian should be subject to a requirement for minimum net free capital of $10,000 or 8% of adjusted liabilities, whichever is greater. A distribution company which made arrangements whereby substantially all money received was paid directly to the mutual fund or its custodian could also avail itself of the latter requirement. We propose in paragraph 13.23 that mutual funds should be prohibited from paying sales or service charges on the sale of their shares or units, so that the latter procedure would not be available in any case where such charges would be levied. The distribution company itself would, then, ordinarily be subject to the requirement for minimum net free capital of the greater of $25,000 or 10% of adjusted liabilities.

7.43 The capital requirements proposed in this section are only one part of an effective registration scheme. At the present time, detailed information is obtained from organizations which apply for registration and this information is considered by the administrator in his decision as to whether registration should be granted. We propose no changes in these existing arrangments, except that they, like the capital requirements themselves, should be kept under continuing review and changed when necessary. To ensure that the administrator is able to adjust the rules for deserving cases, the relevant legislation should permit him to reduce the capital requirements proposed in this section if he considers a reduction to be appropriate in a particular case.

7.44 For the reasons set out in this section, we recommend:

(1) that where organizations to which the following recommendations are applicable are subject to minimum or free capital requirements they should be subject to the following recommendations only if and to the extent that such recommendations are more rigorous than requirements currently applicable to them;

(2) that an application for registration of a mutual fund not operating within the relevant jurisdiction at the effective date of the legislation, as defined in paragraph 7.20, recommendation (1), should not be accepted unless:

(a) shares or units to a value of $50,000 are placed in escrow with a trustee acceptable to the appropriate administrators in all jurisdictions concerned, and the trustee should be subject to a statutory obligation not to permit the transfer or redemption of the shares or units without consent of each such administrator; the beneficial owners of the shares or units should be entitled to receive dividends and exercise voting rights with respect thereto; and

(b) the mutual fund has total net assets of more than $100,000; if it has total net assets of more than $100,000 but less than $300,000, holders of shares or units having a value of $50,000

(other than the shares or units placed in escrow pursuant to clause (a)) should agree in writing not to redeem such shares or units if by so doing total net assets would be reduced below $250,000, and not to transfer such shares or units unless the transferee shall first sign an agreement to the same effect;

(3) that a transfer of the management contract, as defined in paragraph 11.27, recommendation (2) of a mutual fund which is operating within the relevant jurisdiction at the effective date of the legislation and with respect to which there has been no compliance with clause (a) of recommendation (2), should not be permitted unless shares or units are escrowed as contemplated by such clause;

(4) that a mutual fund operating within the relevant jurisdiction at the effective date of the legislation and with total net assets of less than $100,000 should nevertheless be required to register, but public distribution of its shares or units should not be permitted unless and until its total net assets increase to over $100,000 by private sale or otherwise;

(5) that a mutual fund management company which performs no distribution function and therefore is not subject to recommendations (6) to (9) should be required at all times to be in a financial position such that it has a net free capital of at least $1 without taking into account as assets the value of its interest in the management contract or the value of any interest it may have in mutual fund shares or units held in escrow pursuant to the requirement in recommendation (2);

(6) that a ruling substantially equivalent to the Ontario Securities Commission policy ruling on commingling of funds referred to in the footnote to paragraph 7.38 should be applied to all organizations engaged in the distribution of mutual fund shares or units, whether or not they are also members of a self-regulatory association; and that such ruling should be extended to require:

(a) that interest earned on money paid for the purchase of shares

or units before it is invested in the mutual fund be turned over to the mutual fund concerned either as an increase in the amount purchased by the purchaser concerned, or for the benefit of all participants; and

(b) that money received for the purchase of shares or units be transmitted to the mutual fund as expeditiously as possible following the determination of the price of the shares or units purchased;

(7) that distribution companies, brokers and independent sales forces selling mutual fund shares or units to the public should be required to have and to maintain net free capital of not less than $25,000 or 10% of adjusted liabilities, whichever is greater, the terms "net free capital" and "adjusted liabilities" to have meanings given to them by the Ontario Securities Commission policy ruling referred to in the footnote to paragraph 7.21; provided that this requirement would not apply to those organizations that fall within recommendation (8) or recommendation (9);

(8) that brokers and independent sales forces otherwise within recommendation (7) which establish procedures whereby substantially all of the money paid by purchasers of shares or units is paid directly to the distribution company concerned should be required to have and to maintain net free capital of not less than $10,000 or 8% of adjusted liabilities, whichever is greater;

(9) that distribution companies otherwise within recommendation (7) which make arrangements whereby substantially all of the money paid by purchasers of shares or units is paid directly to the mutual fund concerned should be required to have and to maintain net free capital of not less than $10,000 or 8% of adjusted liabilities, whichever is greater;

(10) that the procedure for registration of organizations and the information obtained thereon should be kept under continuing review and changed when necessary, as should the capital requirements proposed in the preceding recommendations; and

(11) that the appropriate administrator should have power to reduce the capital requirements proposed in preceding recommendations where he considers a reduction appropriate in a particular case.

Minimum Capital Requirements for Organizations Making Use of Contractual Plans

7.45 The discussion of minimum capital requirements in the preceding section accords considerable stress to the importance of such requirements in assuring a long-term commitment by participants in the mutual funds industry. This is accentuated when shares or units are sold by way of contractual plan. In such cases, the moral and the financial implications of failure to perform are far greater. This is because the purchaser agrees to the deduction as sales charges of a comparatively large portion of his initial payments, on the understanding that the portion deducted from subsequent payments will be smaller so that the over-all sales charge paid by him will be appropriate.

7.46 In paragraphs 10.109 to 10.115 we make proposals for reductions in the size of the maximum permissible deductions from the initial payments, but even under those recommendations the long-term commitment of the contractual plan sponsor would be considerable. In paragraph 10.120 an example is given of a 120 instalment contractual plan with instalments of $20. Even assuming the implementation of our recommendations, and assuming the continuance of 8.5% of the amount paid as the basic sales charge rate, the deduction for sales charges on instalments after the twenty-fifth might be as little as 94-7/10 cents. Sales charges at the 8.5% rate on such payments would otherwise be $1.70. It is apparent that the contractual planholder who has paid the first twenty-five instalments has a valuable right in that he is entitled to effect the remaining

payments at substantially reduced sales charges. Any intervening factor, such as bankruptcy of the contractual plan sponsor, that prevents him from doing so can have a serious adverse financial impact.

7.47 Because of the long-term commitment involved in the sale of a contractual plan, we have concluded that more rigorous capital requirements should apply to mutual funds the shares or units of which are sold in that way. Because the distribution company associated with a mutual fund is not always able to prevent the sale of its shares or units on a contractual plan basis, this conclusion can be implemented only by a prohibition against the sale of contractual plans for investment in mutual funds with less than the specified minimum amount of total net assets. The minimum amount should, in our opinion, be $1,000,000; this is sufficient to provide reasonable assurance that the mutual fund will continue in existence for the lifetime of the contractual plan. The relevant legislation ought therefore to contain a prohibition against the sale of contractual plans for the purchase of shares or units of mutual funds with less than $1,000,000 in total net assets. The term "contractual plan" is defined in paragraph 10.94.

7.48 The restrictions proposed in the preceding paragraph should be applicable to all mutual funds. If at the date the legislation becomes effective contractual plans are outstanding or are currently being sold for the purchase of shares or units of any mutual fund with total net assets of less than $1,000,000, the legislation should not affect the validity of outstanding plans but the issuance of further plans should be prohibited until the mutual fund attains total net assets in excess of $1,000,000. We are not aware of any mutual fund in Canada to which this provision will be relevant, for all mutual funds known to us in which investments are being made through contractual plans have total net assets in excess of $1,000,000. If a mutual fund with total net assets in excess of $1,000,000 should in future suffer a decrease in total net assets to below $1,000,000, outstanding contractual plans for purchase of its shares or units would not thereby be affected but the sale of further plans should be prohibited until its total net assets again exceed $1,000,000.

7.49 The minimum capital requirement for mutual funds in which investments are made through contractual plans would not apply at the time of registration, since the proposal is framed as a prohibition against the sale of contractual plans rather than as a precondition to the registration of mutual funds. We have therefore concluded that it should operate in addition to rather than in substitution for the escrow and minimum capital requirements proposed in paragraph 7.25.

7.50 The requirements to be applied to distribution companies and other organizations which sponsor mutual fund contractual plans present more difficulties. These difficulties arise largely from the development of contractual plan service companies, which are a consequence of the sale of mutual fund shares or units through brokers and independent sales forces. For competitive reasons, these organizations are often reluctant to advise the distribution company of purchasers' names. They are also reluctant to assume the administrative burden involved in receipt of small monthly payments from contractual plan purchasers, although a few of them have done so. These problems, together with the fact that brokers and independent sales forces sometimes are able to make contractual plan sales of mutual funds whose distribution companies do not themselves offer contractual plans, have resulted in the creation of two companies to service contractual plans sold by brokers and independent sales forces. The companies, C.A.P. Limited and Comptoir Economique de Fonds Mutuel Ltée, have their offices in Ontario and Quebec respectively. They are referred to in this discussion as CAP and Comptoir Economique.

7.51 The principles of operation of the two companies are similar, although there are many differences in detail. Each has created its own contractual plans, and provides client brokers and independent sales forces with documentation for use by persons who wish to purchase shares or units of any of a number of mutual funds under such plans. Payments are made directly to CAP or Comptoir Economique, or to trustees or custodians designated by them. They accumulate the payments received and invest them in shares or units of the mutual funds concerned at regular intervals, monthly or more frequent.

Purchasers are credited with the appropriate number of shares or units, and brokers or independent sales forces are credited with the commissions earned less administrative charges of the service company. Both organizations consider their relationships with client brokers and independent sales forces to be of great value. Names of purchasers are treated confidentially, and commissions received from a purchaser are regarded as the property of the broker or independent sales force which introduced him. This has occasioned difficulties in some cases where brokers or independent sales forces have left the securities business.

7.52 It is of importance that under the arrangements followed by both CAP and Comptoir Economique, the brokers and independent sales forces receive the benefit of the front-end load under the contractual plans. In addition, as noted in paragraph 7.50, a few brokers and independent sales forces handle the administrative burden involved in the contractual plans they sell. We refer to all such brokers and independent sales forces which obtain the direct benefit of the front-end load on contractual plans organized by them as contractual plan sponsors, in the same way that distribution companies which sell by way of contractual plans are contractual plan sponsors. We have considered whether to propose capital requirements for contractual plan sponsors which are more rigid than those applied to other distribution or sales organizations. We have also considered what capital requirements should be applied to contractual plan service companies.

7.53 We have concluded that contractual plan sponsors should not be subject to minimum capital requirements more rigorous than those which would be applicable to them as distribution companies, brokers or independent sales forces. This conclusion arises partly from difficulties in the determination of the formula to be used for minimum capital requirements, but is more particularly a consequence of our conclusion that other provisions are more appropriate to deal with the contractual plan situation. These provisions would also be sufficient to make unnecessary the application of minimum capital requirements to contractual plan service companies. The provisions we propose are discussed in paragraph 8.76.

7.54 For the reasons set out in this section, we recommend:

(1) that sales on a contractual plan basis (the term "contractual plan" is defined in recommendation (1), paragraph 10.125) of shares or units issued by a mutual fund having total net assets of less than $1,000,000 should be prohibited; this recommendation should have no effect on outstanding contractual plans. If, after the legislation becomes effective, contractual plans are sold for the purchase of shares or units issued by a mutual fund having total net assets of more than $1,000,000, and the total net assets of that mutual fund should subsequently decrease to less than that amount, the decrease would not affect outstanding contractual plans but the sale of new contractual plans would be prohibited until total net assets again increased to $1,000,000 or more; and

(2) that contractual plan sponsors should not be subject to minimum capital requirements in excess of those required of them under the recommendation in paragraph 7.44, and that contractual plan service companies should not be subject to minimum capital requirements; in both cases, reliance should instead be placed on the recommendations in paragraph 8.64.

Registration Requirements Applicable to Individuals

7.55 The preceding sections of this chapter are exclusively concerned with the requirements applicable to organizations as preconditions to their participation in the mutual fund industry. Any organization is, of course, made up of individuals, and it would seem logical for a comprehensive regulatory scheme to require the registration not only of organizations but of individuals. Yet very considerable administrative difficulties would be involved in the application of such a requirement, and a decision must be made as to the extent of the advantages to be gained.

7.56 One class of individual should, we have concluded, clearly be subject to registration requirements. Subject to a limited exception discussed in paragraphs 14.14 and 14.15, every salesman engaged in the public sale

of mutual fund shares or units should be required to register as such. A corresponding requirement presently included in the securities legislation of several provinces exempts the officers of registered organizations; we do not consider this exemption appropriate, since we are aware of no reason to assume that a corporate officer is necessarily a qualified salesman. A training course should ordinarily be taken and passed as a precondition to registration as a salesman. This is discussed in paragraphs 14.19 to 14.22, and its application to banks and trust companies is considered in paragraphs 16.07 to 16.28 and 16.52 to 16.56 respectively.

7.57 We have considered whether the officers and directors of mutual fund management companies and distribution companies should be required to register as such if they do not themselves propose to engage in the sale of mutual fund shares or units. While some advantage would be gained from this requirement we have on balance concluded that the advantage would be outweighed by the administrative difficulties involved. Unless and until it is decided that these persons should be required to take training courses, it will be sufficient to continue the existing practice whereby information concerning officers and directors is obtained in connection with applications for registration of their organizations. In addition, the registered organizations should be made responsible for the actions of their officers and directors. To provide the administrator with an adequate remedy, he should be permitted to treat an offence by officers or directors of the management or distribution companies as affecting the mutual fund; such a requirement would constitute a recognition of the fact that the three in fact form a single organization.

7.58 In the preceding paragraph we allude to the possibility that directors or officers who are not to effect public sales of shares or units might eventually be required to take training courses. The only courses presently available, discussed in Chapter XIV, are designed for salesmen. For a number of officers, such as the investment manager, there would be no value to be gained from a requirement that they take a course designed for salesmen. On the other hand, there are instances in which a person who was not directly

involved in the sales process might benefit considerably from the course. We have concluded that the appropriate administrator should have power in cases where he determines that the course would be beneficial, to require that a particular officer (but not a director unless he is also an officer) take and pass the course prescribed for salesmen, although he does not engage in sales activities. If it should become apparent that there is need for a training course designed for those engaged in investment management or in administration, the administrators concerned should be authorized to co-operate with the mutual fund industry in the development of an appropriate course or courses. Ultimately, it might be desirable to require the registration of classes of individuals other than salesmen.

7.59 For the reasons set out in this section, we recommend:

(1) that subject to the exception proposed in paragraph 14.25, recommendation (1), all individuals who are to engage in the sale to the public of mutual fund shares or units should be registered as such and should be required to take appropriate training courses as proposed in paragraph 14.25 and in paragraphs 16.29 and 16.57; and

(2) that separate registration of the officers and directors of mutual funds, management companies, and distribution companies, should not be required except for those who propose to engage in sales to the public, but that:

(a) complete information concerning them should be obtained in connection with the registration of the organization concerned;

(b) the administrator should have power to treat an offence by an officer or director of the management or distribution company as affecting the mutual fund;

(c) each of the organizations should be responsible for a default of its own officers or directors;

(d) the appropriate administrator should have authority to require a particular officer (but not a director unless he is also an officer) to take and to pass the course designated for salesmen

although he does not propose himself to sell mutual fund shares or units; and

(e) the appropriate administrators should have power to co-operate with the mutual fund industry in the development of a course or courses to provide training in aspects of mutual fund operations other than the sales function, and to require that individual participants in the mutual fund industry take and pass the courses so developed.

Consequences of Failure to Satisfy Minimum Capital Requirements

7.60 Most of the regulations recommended in this chapter would constitute requirements the violation of which could be punished through appropriate disciplinary procedures in the same way that violations of securities legislation are presently dealt with. Such sanctions are, however, not appropriate remedies for violations of the requirements proposed in preceding sections as to the amount of capital to be maintained by registered organizations. It is not sufficient to punish those concerned when they fail to maintain adequate capital; in many cases such punishment would be completely inappropriate, for the money may have been lost through no fault on the part of management. Automatic suspension of organizations that violate minimum capital requirements would also be an inadequate remedy. It might severely penalize holders of outstanding shares or units; it might also make inevitable the collapse of an organization which could otherwise have recovered from its difficulties. For these reasons, we have concluded that special provisions are necessary to deal with violations of minimum capital requirements.

7.61 It is convenient here to summarize the suggestions made in preceding sections with which we are concerned. In paragraph 7.25 we propose that mutual funds should be required to have total net assets of at least $100,000 as a precondition to acceptance of their applications for registration. Special requirements are proposed in paragraph 7.28 for mutual funds operating in the relevant jurisdiction at the effective date of the legislation but with less than $100,000 in total net assets. The other minimum capitalization

requirements proposed for mutual funds, that shares or units to a value of $50,000 be placed in escrow and that the sale of contractual plans for the purchase of shares or units issued by mutual funds with total net assets of less than $1,000,000 be prohibited, need not be considered here.

7.62 In paragraph 7.42 we propose that distribution companies, brokers and independent sales forces which receive money from purchasers of shares or units should be required to maintain net free capital at least equal to $25,000 or to 10% of adjusted liabilities, whichever is greater. For those which arrange for such money to be paid directly to the distribution company (or, in the case of the distribution company, to the mutual fund), the corresponding minimum amount would be $10,000 or 8% of adjusted liabilities, whichever is greater. In paragraph 7.30 we propose that management companies should be required at all times to maintain a net free capital of at least $1 without taking into account as assets the worth of the management contract or of any beneficial interest in shares or units of the mutual fund escrowed pursuant to the requirement suggested in paragraph 7.25.

7.63 We have concluded that the remedies available when default occurs under any of the requirements outlined in preceding paragraphs should be identical. This is consistent with our belief that the mutual fund management company and distribution company should be considered to form a single organization for regulatory purposes. Whether the failure to satisfy the relevant requirements is that of the mutual fund, the management company or the distribution company, the consequences for the mutual fund and its shareholders or unitholders are likely to be made more serious if arbitrary remedies are applied. The use of discretionary authority on a case-by-case basis is necessary to ensure that a solution is found in the best interests of all concerned.

7.64 We have concluded that notice should be required to be given forthwith to the appropriate administrator if total net assets of a mutual fund decrease to less than $100,000, or if the management company or the distribution company fails to satisfy the minimum capital requirements described in

preceding paragraphs. If the responsible person in the organization concerned knows, or is in possession of information which should make him aware, that any of these events has occurred, and fails to give the requisite notice, he should be guilty of an offence punishable as such under the penalties provision of the relevant legislation. If the default is not cured within three business days after its occurrence, the administrator should have authority to apply for a court order that a receiver be appointed for the defaulting organization. If the default was that of the management company or distribution company, this application could also relate to the mutual fund. We view such an application as an ultimate remedy that would only be used in practice in the most serious situations, and after alternative approaches had failed. To provide time to devise alternative approaches, delay on the part of the administrator in making the application should not affect its success; the legislation should provide that the application could be made at any time after the three day period until the default was rectified.

7.65 If any mutual fund operating within the relevant jurisdiction has less than $100,000 in total net assets at the effective date of the legislation, the remedy of a receivership application should not apply to it without its consent. The fact that a public distribution of its shares or units would, under the proposals in paragraph 7.28, be prohibited unless and until the total net assets of such a mutual fund exceeded $100,000 might make a liquidation desirable. Either the mutual fund or its management company should therefore be permitted to consent to the appointment of a receiver.

7.66 In cases where it is found necessary to apply for and to obtain appointment of a receiver of the mutual fund, the legislation should provide that the shares or units held in escrow pursuant to the proposal in paragraph 7.25 be made available for the benefit of the receivership, and that they could be liquidated with the approval of the court to contribute to the cost of receivership. This would reduce or eliminate the costs of receivership borne by public holders of shares or units. In addition, the receiver should be given the option to elect whether to continue or to terminate the management and distribution contracts. Regardless of the provisions of those contracts, no damages would be payable in the event the receiver elected to terminate them.

7.67 The application for appointment of a receiver should be made only as a last resort. Upon receipt of notice that a default had occurred, the administrator should discuss the situation with the persons responsible for the management of the mutual fund and with the other organizations concerned. The administrator should have power to negotiate and agree to such arrangements as might be necessary and desirable. Permissible arrangements should include, for example, the termination of distribution of shares or units; the termination of redemptions of shares or units for a period of time; or any appropriate portfolio adjustments. Ideally, the situation could be rectified through the contribution of additional money by the holders of the equity securities of the management company and the distribution company. With flexibility available to agree to accept any or all of these solutions, alone or in combination, we think it would rarely be necessary for the administrator to resort to the drastic remedy of appointment of a receiver.

7.68 We have concluded that one other power should be entrusted to the appropriate administrator in addition to those outlined above. If he determines that persons associated with the mutual fund, the management company or distribution company had presented their shares or units for redemption after becoming aware of impending difficulties, he could apply to the court for an order setting aside such redemptions. If the court found that the redemption was motivated by the knowledge of impending difficulties, it could order that the money paid on redemption be refunded, and that the shares or units redeemed be re-issued. The legislation should establish a presumption that the redemption was so motivated if it took place less than 90 days prior to the occurrence of the violation, and was effected by a person with knowledge that a violation was likely to occur.

7.69 For the reasons set out in this section, we recommend:

(1) that for purposes of the following recommendations each of the following events should be considered to be an event of default:

(a) when a mutual fund experiences a decrease in total net assets to an amount less than $100,000;

(b) when a distribution company ceases or fails to comply with the minimum capital requirements contained in paragraph 7.44, recommendation (7) or recommendation (9), whichever is applicable; and

(c) when a management company ceases or fails to comply with the minimum capital requirements contained in paragraph 7.44, recommendation (5);

(2) that the responsible persons in the organization concerned should be required to notify the appropriate administrator forthwith upon the occurrence of an event of default and should be guilty of an offence punishable as such under the penalties provision of the relevant legislation if they fail to give the notice when they are aware of an event of default, or are in possession of information which should make them aware of it;

(3) that the appropriate administrator should have the right, at any time more than three business days after the occurrence of an event of default and until the event of default is rectified, to apply for and to obtain the appointment of a receiver of the organization which has committed an event of default; where the event of default is committed by the management company or by the distribution company, the receivership order could also relate the mutual fund;

(4) that in the event of the appointment of a receiver pursuant to recommendation (3), the receiver should have the right to shares or units of the mutual fund held in escrow pursuant to paragraph 7.44, recommendation (2), clause (a), and should have the right to elect whether to continue or to terminate the management and distribution contracts; regardless of the contractual provisions, no damages should be payable in the event that the receiver should elect to terminate the contracts;

(5) that, in our opinion, the power of the administrator pursuant to recommendation (3) should be exercised only in particularly serious cases, or after attempts have been made to resolve the situation

in accordance with recommendation (6) and such attempts have proven unsuccessful;

(6) that the appropriate administrator should have authority to negotiate with the responsible persons for an alternative remedy to the appointment of a receiver, and to accept and agree to such arrangements as might be necessary and desirable. Permissible arrangements should include, but not be limited to, the termination of distribution or redemption of shares or units; portfolio adjustments; or the addition of more money by interested persons; and

(7) that the court on application by the appropriate administrator should have power, where it finds that a redemption of shares or units of the mutual fund was effected by the management company, the distribution company or a person associated with them or with the mutual fund, and was motivated by knowledge of an impending event of default, to order that the redemption be set aside, the money repaid and the shares or units reissued; where the court finds that the redemption was effected within 90 days prior to the occurrence of the event of default by a person with knowledge that an event of default was likely to occur, the redemption would be presumed to have been motivated by knowledge of an impending event of default.

CHAPTER VIII

CUSTODIAL AND INSPECTION REQUIREMENTS; CONTRACTUAL PLAN SPONSORS

8.01 In the preceding two chapters we consider and make recommendations concerning techniques designed to avoid improper use of mutual fund assets. The techniques there discussed are general in nature, designed to guard against all types of risk by providing for continuing scrutiny of mutual fund management or by restricting admittance to the industry to persons who are honest and financially stable. In this chapter and Chapter IX we discuss procedures designed to attain a similar objective through a different approach, concentrating on specific procedures designed to thwart various types of improper use of assets.

8.02 The very nature of the subject matter of this chapter makes it inevitable that the discussion should emphasize potential misbehaviour on the part of those concerned with the operation of mutual funds. For example, the proposals concerning custodial procedures must be analyzed on the basis that theft of assets may be attempted. It is regrettable that this emphasis should be necessary, and no judgments as to industry standards should be implied from it. The procedures we propose are in many respects similar or identical to those established by mutual fund management companies on their own initiative. This is a matter of prudent business practice, for it is to the interest of management as of investors to avoid any possibility that assets of the mutual fund might be dealt with on an unauthorized basis. In many cases, the procedures established by management companies are more stringent than

those we propose. That very fact should refute any adverse implications concerning industry practices which might otherwise be based on the discussion and proposals in this chapter. The procedures and requirements we propose are designed for the exceptional case.

8.03 Much of this chapter is concerned with questions which are dealt with, directly or indirectly, by the Ontario Securities Commission policy ruling of February, 1969 referred to in the footnote to paragraph 7.21. The comment there made concerning that ruling is also applicable here: it makes a valuable contribution to the articulation of policy in this area, and to the extent that our proposals differ from it the differences arise from our belief that there are certain distinctive factors to be considered with respect to mutual funds which could not be fully reflected in a policy ruling applicable to the entire securities industry. That policy ruling incorporates a special audit procedure applicable to mutual funds, which is discussed in paragraphs 8.65 to 8.77.

8.04 In the following sections we first consider the custody of assets, including not only the securities and other investments of the mutual fund, but also the shares or units of the mutual fund which are held by a custodian on behalf of their beneficial owners. Closely related to the latter arrangements are the special requirements which, we have concluded, should apply to contractual plans and their sponsors. These are discussed after custodial requirements. Finally, we consider inspections of the mutual fund and its methods of operation and by whom such inspections should be made. This is a topic omitted from Chapter VI, although it may be said to involve the continuing scrutiny of management. As noted in paragraph 6.11, that chapter is confined to techniques for continuing scrutiny which can operate with minimal governmental involvement, and the inspection techniques we propose require governmental involvement.

Custody of Mutual Fund Assets

8.05 There is a tendency to look to custodial requirements as the resolution of many difficulties or potential difficulties in the operation of mutual funds. So natural is this tendency that it is important to appreciate

the limited nature of the problems which could be resolved even by the most extensive and detailed requirements. Unless the responsibilities of the trustee or the custodian are extended to include the duty and the power to pass on the merits of investments, an extension we reject in paragraphs 6.60 to 6.68, custodial requirements cannot pose an obstacle to improper investments; if an investment is duly authorized it can be made regardless of the most stringent custodial requirements. Nor would custodial requirements applicable to the assets of the mutual fund affect dealings with money paid by purchasers prior to the time of its receipt by the mutual fund; in paragraphs 7.38 and 7.41 we propose restrictions on commingling of assets designed to restrict the uses to which such money is put. Custodial requirements can only be effective as a precaution against the theft of assets.

8.06 In the formulation of recommendations concerning the custody of assets, as in other aspects of the regulatory structure, it is necessary to sacrifice what is desirable in theory for what is possible in practice. The limited nature of the objectives of custodial requirements are relevant here. Theoretically and ideally, custodial procedures should be sufficient to prevent theft of assets by anybody, even senior officers of the management company working in combination. Yet such an objective would not be realistic. Requirements adequate to attain it would be so complex and demanding as to be unworkable, and any senior officer prepared to engage in fraudulent activities could almost certainly extract money from the mutual fund more subtly than by outright theft. It is far more realistic to recognize that a determined effort at theft by responsible persons working in combination will almost certainly be successful, and to shape custodial requirements to avoid other types of theft while imposing obstacles to theft by responsible persons and providing procedures whereby any theft would be expeditiously discovered. The proposals made in the following paragraphs are designed to attain these objectives with a scheme which will not impede the efficient operation of the mutual fund. Many organizations may wish to institute more rigorous procedures than those we propose.

8.07 There is an important connection between custodial requirements and insurance. Not only will insurance, particularly bonding of officers, directors and employees, provide the mutual fund with cash to indemnify it against a theft, but insurance will also protect against other types of loss. Custodial requirements can, for example, do little to protect against fire or similar losses. It is important that the two types of requirement be considered together; the availability of adequate insurance may justify less rigorous custodial requirements. In addition, the insurance company may well demand acceptance of more rigid custodial requirements as a precondition to the issuance of a policy. Insurance must, however, be considered as an adjunct to custodial requirements rather than as a substitute for them. We believe that an adequate regulatory scheme must encompass both custodial and insurance requirements. The latter are considered in paragraphs 8.25 to 8.39. In the following paragraphs we consider custodial requirements, discussing the relevant questions in the following order: the place of custody (paragraphs 8.08 to 8.10); the qualifications of the custodian (paragraphs 8.11 to 8.14); the terms of the custodial agreement, including the arrangements for release of assets from custody (paragraphs 8.15 to 8.22); and procedures for the amendment of the custodial agreement (paragraph 8.23).

8.08 We have concluded that mutual funds registered in Canada should be subject to a generally applicable rule requiring that their assets, or the securities or negotiable instruments representing them, be kept in custody in Canada; only thus can the Canadian investor be assured adequate protection against foreign legal requirements which might otherwise penalize him. To permit assets to be kept anywhere, without restriction, would subject the mutual fund to a risk of loss that might be unacceptable; the dangers might be particularly serious where Canadian investors had to compete against foreign investors for assets situate in the foreign country. We recognize, however, that the proposed requirement would occasion considerable difficulty for Canadian mutual funds with non-Canadian assets. It would occasion even more difficulty for some mutual funds organized outside Canada; the most important example would be mutual funds subject to the Investment Company Act

of 1940 in the United States. By a similar provision of that Act they are required to retain all their assets in that country. Compliance with both provisions would be impossible for them.

8.09 In recognition of the factors described in the preceding paragraph, the appropriate administrator should have a wide power to exempt mutual funds from the requirement that their assets be kept in Canada. The exemption could be granted upon such conditions as the administrator thought fit. This power should be liberally exercised in favour of Canadian-organized mutual funds upon a showing that reasonable protection was available under custody arrangements outside Canada. The power should be more sparingly exercised in favour of mutual funds organized in other countries, for the authority of Canadian administrators would not be as strong in case of financial difficulties on the part of the mutual fund in such cases. To permit the continued Canadian operations of mutual funds subject to the 1940 Act which are operating within the relevant jurisdiction when the legislation becomes effective, such mutual funds should be granted an initial exemption subject to reconsideration if the negotiations for exemptions to the 1940 Act on behalf of Canadian mutual funds which are recommended in Chapter XVI are not effective. The conclusions in paragraph 7.10 should be applicable in the determination of what mutual funds are operating in the relevant jurisdiction when the legislation becomes effective.

8.10 A number of mutual funds qualified for sale in Canada invest exclusively in the shares or units of another mutual fund. An exemption for such mutual funds from the rules applicable to funds on funds is proposed in paragraph 12.90. For adequate protection, the custodial requirements in such cases should be applied to both mutual funds concerned, so that the assets of the underlying mutual fund would be required to be kept by a Canadian custodian, unless an exemption was obtained from the administrator. This requirement would not apply to the mutual funds invested in by funds on funds, although the extent to which they would be permitted to invest in mutual funds not registered in Canada would be restricted by the proposals in paragraph 12.88.

8.11 Given that the assets of a mutual fund registered in Canada are to be kept in custody in this country unless an exemption order is obtained, the next question to be resolved is the qualifications of the custodian. The most difficult aspect of this is whether the selection should be restricted to custodians who satisfy a statutory standard of independence from the mutual fund and its management company. There are obvious advantages in an independent custodian; regardless of the terms of the custodial agreement, an independent custodian is likely to take appropriate action if he becomes aware of improper practices. In addition, employees of an independent custodian are less likely than would be those of an associated custodian to form relationships with employees of the mutual fund or management company. Largely as a result of these factors, the great majority of custodians for mutual fund organizations are in fact independent, even in the absence of statutory requirements to that effect. Precise statistics are impossible in the absence of an agreed definition of independence, but we are aware of only three instances in Canada apart from the trust company investment funds in which the custodian is clearly associated with the management company. One of these is Diversified Income Securities Ltd., which forms part of the Commonwealth organization of Vancouver, the financial difficulties of which are referred to in the preface to this report.

8.12 Despite the fact that the use of independent custodians is practically universal, we have concluded that it should not be made obligatory by statute. One reason for this conclusion lies in the difficulties inherent in an attempt to reduce to legislative form a definition of independence. Such difficulties are alluded to in connection with independent directors in paragraphs 6.31 to 6.44, and would be at least as serious in the present context. Another reason is that we do not feel justified in recommending the imposition on mutual funds of custodial requirements that involve the use of an independent custodian when similar requirements are not imposed on other financial institutions. Finally, we doubt that much would be gained by such a requirement when independent custodians are almost universally used even without it; a mutual fund organization determined not to have an indepen-

dent custodian would be able to make arrangements that would avoid any but the most rigorous definition of independence. It is, however, important for information as to any connection between the custodian and the mutual fund, management company or distribution company to be made public. Such information should therefore be included in the prospectus of the mutual fund.

8.13 While we have concluded against a statutory requirement for the independence of custodians, we have also concluded that the appropriate administrator should have power to require that his approval be obtained for the selection of the custodian in any case where he is not satisfied with the good faith or the financial position of management. In paragraphs 8.17 and 8.23 we propose that the custodial agreement and all amendments should be filed with the appropriate administrator. This would include information as to the identity of the custodian, and the procedure contemplated by paragraph 8.23 should be applicable with respect to a change in the identity of the custodian so that the administrator could require that the approval of shareholders or unitholders be obtained for such a change.

8.14 Apart from the question of independence, we have concluded that restrictions should be imposed on the selection of custodians in order to ensure that duly qualified organizations are appointed. The only organizations that traditionally act in this capacity in Canada are banks and trust companies, but we do not believe that the right so to act should be restricted to these organizations. We have concluded that a registered mutual fund's assets should ordinarily in the absence of an applicable exemption, be held by one or more custodians qualified to act in that capacity in Canada. The custodians could be banks, trust companies, or other financial institutions subject to inspection by federal or provincial regulatory authorities, and should each have an excess of capital over liabilities of not less than $500,000. While the custodian or custodians need not be independent of the management company, that company should not be permitted itself to act as custodian. The application of this prohibition to trust company investment funds is considered in paragraph 16.56.

8.15 The applicable regulations should delineate not only the qualifications of the custodian, but also the minimum responsibilities to be assumed by the custodian. The responsibilities of the custodians of a number of Canadian mutual funds do not at present include the custody of cash. Cash belonging to such mutual funds is kept in bank accounts from which it may be withdrawn by cheques, so that the procedural protections applied to use of other assets are not available. Large amounts may be held in this way, particularly when the volume of purchases of shares or units is high or when for policy reasons a significant portion of the portfolio is liquidated. We have concluded that it is important for custodial controls to extend to cash, although a separate custodian could be appointed to hold the cash if that was more convenient. The application of such controls is essential, since theft of cash may be even more attractive than theft of securities. In the discussion and recommendations which follow, we qualify this conclusion by proposals which will facilitate quick access to cash when circumstances warrant.

8.16 The responsibilities of custodians for assets other than cash differ appreciably among Canadian mutual fund organizations. It is convenient to divide the arrangements usually followed into two general categories, although details vary far more than this brief description would indicate. In the first category, the custodian merely accepts instructions from the designated officer or officers of the management company or the mutual fund: securities may be withdrawn or added, or delivered to third parties, on the order of those officers. In the second category, the custodial agreement spells out the circumstances in which securities will be released. The custodian in these cases will release securities only upon production of appropriate proof that the terms of the agreement are satisfied. For example, when securities are sold the certificate may not be delivered except upon receipt of a confirmation of the transaction.

8.17 It is clear that the quality of protection for the investor is better under the second than under the first of the custodial arrangements described in the preceding paragraph, and we have concluded that such an arrangement should be required for all mutual funds. The custodial agreement

should specify in detail the purposes for which assets of the mutual fund, including cash, may be released from custody, and the nature of the proof required that such circumstances are present before a release is made. We do not propose that the various circumstances should be set out in the legislation or regulations; they could be formulated to fit the needs of the particular case. Examples of situations to be dealt with include the purchase or sale of investments; the delivery of securities in connection with a re-organization of the company concerned; the payment of management fees, dividends, and other expenses. The agreement should be filed with and received by the appropriate administrator at the time of registration so he may verify that these matters are dealt with. The procedure to be followed on amendment of a custodial agreement is discussed below.

8.18 To prevent undue interference with the operation of the mutual fund, requirements implementing the conclusion reached in the preceding paragraph should embody two exceptions. The first exception would permit the operation of one or more bank accounts from which money could be drawn to pay routine expenses, on the authority of cheques signed by two officers or directors of the mutual fund or the management company. The aggregate of the amounts deposited in the account or accounts should not be permitted to exceed an amount specified in the prospectus as necessary for the purpose.

8.19 The second exception from the general requirement proposed in paragraph 8.17 would be designed for use in rare situations when it is necessary to withdraw securities or cash from custody but for some reason the appropriate proof required under the custodial agreement could not be produced. The custodial agreement could provide that in such circumstances two officers or directors of the mutual fund or management company could obtain delivery of securities or cash on the basis of a written order to the custodian which would indicate the reasons why they were needed. The custodian would be required to send a copy of the order immediately to a third officer or director of the mutual fund or management company, and to the appropriate administrator.

8.20 The right of the custodian to send advice to the appropriate administrator should not be restricted to the exceptional case described in the preceding paragraph. In any case where, in the opinion of the custodian, the nature of the receipts or releases of cash or securities was such as to provide evidence of improper transactions, it should have the right to notify the appropriate administrator; if the evidence is of illegal transactions, there should be a requirement for such notification. These provisions would be similar to those applicable to the mutual fund auditor under the proposals in paragraphs 6.85 and 6.86. The right and requirement should be clearly specified in the relevant legislation.

8.21 The procedures outlined above are primarily designed to guard against the possibility of theft of assets of the mutual fund. Other types of loss would be dealt with by the insurance requirements proposed in the next section, but we have concluded that the custodial agreement should contain certain additional provisions designed to guard in part against theft and in part against other types of loss. The first such additional provision is that, where reasonably feasible, all securities should be registered in the name of the custodian as nominee of the mutual fund, or a nominee of the custodian. Where not so registered, the securities should be endorsed to the satisfaction of the custodian. Not only are fully registered securities less susceptible to theft by officers or employees of the mutual fund or management company, but they can be replaced if stolen or if lost by fire or other accident. This requirement is an important one which adds significantly to the value of a custodial arrangement.

8.22 Other provisions that should appear in every custodial agreement include an obligation on the custodian to segregate assets of the mutual fund, other than cash, from those of other clients, and to mark them appropriately for identification while in its custody. The agreement should also specify that the assets are not subject to liens or pledges in favour of the custodian or its nominees, and should prohibit the custodian from dealing with the assets except on proper authority. In addition, it seems

reasonable in view of the position of the custodian that the agreement should state that, in the event of loss or damage of the assets while held by the custodian, the onus should be on it to disprove that the loss or damage took place through its negligence or that of its employees. We have considered what treatment is appropriate for cash, other than cash held in bank accounts as contemplated by paragraph 8.18. We have concluded that the custodian should ordinarily be permitted to receive cash as depositary rather than as a trustee, with one exception. Since a deposit is a loan, such arrangements would be caught by the prohibitions proposed in Chapter IX if the custodian is associated with the mutual fund.

8.23 It is apparent from the discussion in this section that we accord considerable importance to the terms and content of the custodial agreement. As stated in paragraph 8.17, a copy of the agreement should be required to be filed for every registered mutual fund. In addition, at least fourteen days' prior written notice should be given to the appropriate administrator of any proposed amendments thereto. Most amendments will presumably be routine in nature, but some could be of considerable importance. We have concluded that the appropriate administrator should have authority, where he regards a proposed amendment as of particular importance or as potentially adverse to the interests of the mutual fund, to require that it not be implemented without prior approval of the holders of the mutual fund shares or units. Such approval would be given in accordance with the provisions enacted in accordance with paragraph 6.57.

8.24 For the reasons set out in this section, we recommend:

(1) that the assets, or the securities or negotiable instruments which represent the assets, of a mutual fund registered in Canada, should be kept in custody in Canada; this should include the assets of any mutual fund the shares or units of which are the only investment purchased by a mutual fund registered in Canada, but should not include the assets of mutual funds invested in by funds on funds. This recommendation is subject to the following exceptions:

(a) the appropriate administrator should have power to grant exemp-

tions subject to compliance with such conditions as he may think fit, where administrative or other problems make compliance difficult and reasonable protection can be accorded investors through another procedure; this power should be liberally exercised in favour of Canadian-organized mutual funds; and

(b) pending negotiations to establish appropriate mutual exemptions with the United States as proposed in paragraph 16.70, recommendation (3) the appropriate administrators should exercise their exemptive power in favour of mutual funds which are subject to the Investment Company Act of 1940, and are operating within the relevant jurisdiction on the effective date of the legislation, as defined in paragraph 7.20, recommendation (1); such exemptions should be reconsidered if the negotiations are not effective;

(2) that every registered mutual fund should have as custodian one or more banks, trust companies, or other financial institutions qualified to act in that capacity and subject to inspection by federal or provincial regulatory authorities, provided that each custodian should have an excess of capital over liabilities of not less than $500,000 and further provided (subject to paragraph 16.57, suggestion (2) with respect to trust companies) that the custodian should not be the management company;

(3) that there should be no statutory requirement for the independence of custodians, but that the appropriate administrator should have power in any case where he is not satisfied with the good faith or the financial position of management, to require that a custodian not be appointed without his approval; and that the prospectus of each mutual fund should include details of any connection between the custodian and the mutual fund, management company or distribution company;

(4) that subject to recommendations (1), (5) and (6), the responsibility of the custodian or custodians should extend to all assets of the mutual fund, including cash; with respect to cash, the custodian should,

subject to the recommendations in Chapter IX, be permitted to act as depositary rather than as trustee, and it should be permissible to appoint a separate custodian to hold cash;

(5) that subject to the exceptions in recommendation (6), the custodial agreement should specify the circumstances in which assets of the mutual fund, including cash, could be released from custody, and the nature of the proof required that such circumstances were present; the custodian should, subject to recommendation (6), be required to obtain such proof before releasing securities or cash;

(6) that to avoid undue restrictions on the freedom of operations of the mutual fund, custodial agreements should be permitted to contain the following exceptions from the requirements contemplated by recommendation (5):

(a) one or more bank accounts may be opened with cash of the mutual fund against which two or more officers or directors of the mutual fund or the management company may draw cheques to pay routine expenses of the mutual fund; the total amount deposited in such account or accounts should at no time exceed an amount specified in the mutual fund prospectus as necessary for that purpose; and

(b) in cases (which should be rare) when release of cash or securities is required, and the requisite proofs contemplated by recommendation (5) cannot be supplied, the custodian would release the securities or cash upon receipt of an order signed by two officers or directors of the mutual fund or management company specifying why the securities or cash were needed; the custodian would be required immediately to send copies of the order to a third officer or director and to the appropriate administrator;

(7) that the custodian should be permitted but not required to notify the appropriate administrator if the nature of receipts or releases of cash or securities is, in its opinion, such as to provide evidence

of improper transactions, and should be required to notify the administrator forthwith if the evidence appears to indicate illegal transactions;

(8) that the custodial agreement should provide:

(a) that, where reasonably feasible, all securities held should be registered in the name of the custodian, or its nominee, as nominee of the mutual fund; if such registration is not feasible, the securities should be endorsed to the satisfaction of the custodian;

(b) that assets of the mutual fund, other than cash, should be segregated from the assets of the custodian and appropriately marked for identification; cash should be held as contemplated by recommendation (4) or recommendation (6), clause (a);

(c) that the assets of the mutual fund are not subject to liens or pledges in favour of the custodian or its nominees;

(d) that the custodian is prohibited from dealing with the assets except on proper authority; and

(e) that, in the event of loss or damage to assets of the mutual fund while in the custody of the custodian, the onus shall be on the custodian to disprove that the loss or damage took place through its negligence or that of its employees; and

(9) that a copy of the custodial agreement should be filed with the appropriate administrator at the time of registration of the mutual fund and should be reviewed by him to verify that it complies with these recommendations, particularly recommendations (5), (7) and (8); the administrator should be given fourteen days' prior notice of any proposed amendment to the custodial agreement or any change in the identity of the custodian and should be entitled to require that any such amendment or change not be implemented without prior approval of the shareholders or unitholders pursuant to paragraph 6.59.

Bonding and Other Insurance

8.25 In paragraph 8.07 we comment on the close relationship between insurance and custodial requirements, and conclude that an adequate regulatory scheme should include both. In this section we discuss the nature of the provisions that we would consider to be appropriate with respect to insurance. In the formulation of such provisions even more than in the formulation of minimum capital and solvency requirements, substantial difficulties are posed by the lack of uniformity among the affected organizations. The variances, both as to size and as to practices and procedures followed, are so great that we have concluded it would be impossible to devise a detailed set of rules which could be used to determine with precision the appropriate insurance coverage for every organization.

8.26 Because of the impossibility of arriving at a detailed set of rules for universal application, the ideal regulatory structure would avoid the use of specific dollar figures to determine the necessary amount of insurance coverage. Instead, appropriate coverage would be determined separately for every organization. Such an ideal is impossible of attainment, and we have concluded instead that the applicable regulations should specify minimum amounts of coverage but should also include provisions to ensure that careful consideration is given by the organizations concerned and by the appriate administrators to the adequacy of the minimum amounts for each participant in the industry.

8.27 Material which verifies that the organizations concerned have given careful consideration to their insurance needs should be filed with the appropriate administrator at the time of initial registration of a mutual fund, management company or distribution company. This material would consist of certified copies of resolutions or other evidence to establish that the board of directors or equivalent body of each organization (in the case of an unincorporated mutual fund with no board of governors or equivalent body, the resolution should be of the board of directors of the management company) had carefully considered the question of insurance and had concluded

either that the minimum amounts were adequate, or that greater coverage was desirable. In the latter case, the resolution or other document should specify the exact amounts of coverage decided upon. Such amounts would then be regarded as minima for the organization concerned until an amending resolution or similar document was filed with the appropriate administrator. A decrease in coverage below the minimum limits currently in effect should be prohibited until fourteen days following the filing of the amendment.

8.28 The requirement proposed in the preceding paragraph should be supplemented by a provision designed to permit the appropriate administrator to pass upon the adequacy of insurance coverage in individual cases. The administrator should have authority to require that the insurance coverage held by any organization be increased, on being satisfied that present coverage does not provide adequate protection. This would be one of the questions to be considered on the occasion of the regular inspections discussed in paragraphs 8.69 to 8.75.

8.29 As indicated in paragraph 8.26, the requirements proposed in the two preceding paragraphs should be supplemented by provisions specifying the minimum insurance coverage required of all organizations. In the decision as to what minimum coverage is appropriate, it is convenient for analytical purposes to divide insurance into two categories. The first, and the more important in the context of mutual funds as with other financial institutions, is insurance against losses caused by dishonesty on the part of the directors, officers and employees of the organization. The second category includes insurance against all other types of loss, such as theft, forgery and burglary. In the following discussion we first consider fidelity insurance or bonding, the terms used to describe insurance against losses caused by dishonesty of directors, officers or employees.

8.30 The discussion of custodial requirements in the preceding section is premised on the assumption that two or more senior employees of the management company, acting in collusion, would probably be successful in the theft of assets unless the custodial procedures are made so detailed

and complex as to be unworkable. It is also almost inevitable that, no matter how carefully defined are the various procedures, occasions will arise when even comparatively junior employees could steal money or other assets, although perhaps rarely in large amounts. Such occasions would include any case where money or securities were in transit in the custody of messengers or other employees. The rarity of such thefts is reflected by comparatively low premiums usually charged for bonding, and does not negate the desirability of this type of protection.

8.31 Given that custodial procedures cannot feasibly be designed to provide complete protection against theft, it seems clear to us that personnel who are in a position to steal should be appropriately bonded. Two types of protection are afforded by such a requirement: the availability of cash to pay claims and the fact that the insurance company will usually reject an application for bonding of an employee with a poor record. In principle, the size of the bond and the nature of the losses for which recovery could be claimed should be determined on the basis of the scope of responsibility held by the person concerned, and the ways in which it would be open to him to steal. Only limited weight can be given these factors in the rules of general application, but considerable weight should be accorded to them by the board of directors or equivalent body in the consideration contemplated by paragraph 8.27.

8.32 We have concluded that the factors discussed in the preceding paragraph should be recognized in the imposition of a higher bonding requirement for those who are authorized to give instructions concerning the delivery of assets of the mutual fund than for other employees. We have considered and decided against a recommendation that the amount of the bond to be required on such an employee should be determined as a percentage of the total value of the assets over which he has control; such a requirement might be unreasonably rigorous. The only exception concerns bank accounts opened in the name of the mutual fund as contemplated by paragraph 8.18. Each person authorized to sign cheques drawn against such accounts should be

covered by a bond or by fidelity insurance in an amount at least equal to the maximum aggregate amount of such accounts specified in the mutual fund prospectus but in no event less than $150,000.

8.33 All directors, officers and employees of the mutual fund, management company and distribution company who are authorized, alone or together with one or more other persons, to give instructions concerning the delivery of assets of the mutual fund should be covered by bonds or fidelity insurance in an amount that recognizes the nature of their responsibility. For mutual funds which, alone or together with other mutual funds under common management, have total net assets in excess of $5,000,000, minimum coverage should be $600,000. For all other mutual funds minimum coverage should be $250,000. Other personnel who from time to time have access as messengers or in clerical or similar capacities to assets of a mutual fund should be similarly covered by bonds or fidelity insurance in amounts not less than one-half of these minimum limits.

8.34 The conclusions in the two preceding paragraphs relate only to persons with access in some capacity to the assets of the mutual fund. Consideration must also be given to other personnel, and in particular to those who have or may have access to money paid by purchasers prior to its receipt by the mutual fund. The latter are most likely to be associated with the distribution company. The Ontario Securities Commission in its policy ruling of February, 1969* deals specifically with this question, and requires that fidelity insurance with minimum coverage of at least $100,000 be obtained by the distribution company and other organizations engaged in the distribution process. We agree with this policy, and have concluded that distribution companies and others engaged in the sale to the public of mutual fund shares or units should have fidelity insurance or bonds with minimum coverage of at least $100,000 for all directors, officers and employees. The same minimum coverage should apply to directors, officers and employees of the management company and of the mutual fund to whom no other requirement

* Ontario Securities Commission, Policy Statement on Conditions of Registration, February 17, 1969, as subsequently amended.

is applicable. In cases where two or more of the requirements proposed in this and preceding paragraphs apply to a single person, the limits under the more rigorous requirement should be complied with.

8.35 In the second category of insurance defined for analytical purposes in paragraph 8.29, insurance against all other losses, we have concluded that the range of possible types of loss is so great that detailed legislative specification of the risks to be protected against would be of little value. Instead, regulations should embody a list of risks that would be capable of ready adaptation to reflect experience. In a footnote* we set out the types of losses against which members of the Canadian Mutual Funds Association are required to obtain insurance under the regulations of that Association. Class A is covered by the specific recommendations made above concerning bonds and fidelity insurance. Classes B to E would, we have concluded, be appropriate for initial adoption in the regulations to describe the risks insured against.

8.36 The C.M.F.A. requires its members to carry $500,000 in protection against each of the classes of risk described in the footnote to the preceding paragraph, except classes D and E, for which the required cover-

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* CLASS (A) LOSSES - Any loss through any dishonest, fraudulent or criminal act of any officer or employee.

CLASS (B) LOSSES - Any loss of money or securities or other property through robbery, burglary, theft, hold-up or other fraudulent means, misplacement, mysterious disappearance, damage, or destruction while within any of the the insured's offices, the offices of any banking institution or clearing house or within any recognized place of safe-deposit.

CLASS (C) LOSSES - Any loss of money, or securities, or other property through robbery, embezzlement, theft, hold-up, misplacement, mysterious disappearance, damage or destruction, while in transit in the custody of any employee or any person acting as messenger except while in the mail or with a carrier for hire other than an armoured motor vehicle company.

CLASS (D) LOSSES - Any loss through forgery or alteration of any checks, drafts, promissory notes or other written orders or directions to pay sums in money, excluding securities.

CLASS (E) LOSSES - Any loss through having purchased or acquired, sold or delivered, or extended any credit or acted upon securities or other written instruments which prove to have been forged, counterfeited, raised or altered, or lost or stolen or through having guaranteed in writing or witnessed any signatures upon transfers, assignments or other documents or written instruments.

age is $100,000. With these types of insurance, as with fidelity insurance, we have concluded that it is desirable to distinguish between organizations on the basis of their total net assets. The minimum requisite amount of insurance for mutual funds which, alone or together with other mutual funds under common management, have total net assets in excess of $5,000,000, should be $600,000 against the losses in classes B and C, and $250,000 against the losses in classes D and E. Corresponding minimum coverage for other mutual funds should be $250,000 and $100,000.

8.37 The requirements proposed in preceding paragraphs should be kept under continuing review by the appropriate administrator, both as to types of risk insured against and as to the minimum coverage that is required. The insurance would ordinarily be held by the management company or the distribution company, and one question which should concern the administrator is the relevance to the minimum limits of other activities carried on by these companies; a management company actively engaged in other businesses may need higher coverage. This and similar questions should be considered in the context both of the generally applicable rules and of the adequacy of the minimum limits as applied in individual cases.

8.38 Each insurance policy issued in satisfaction of the requirements proposed in this section should be required to contain a clause specifying that no cancellation or amendment by either party will be effective unless and until fourteen days' prior written notice of the cancellation or amendment is given to the appropriate administrator. This provision will enable the administrator to require that appropriate action be taken when a policy is cancelled. The policies should also, in all cases, contain provisions that will make the protection available for a loss resulting from an insured risk if the loss is discovered within two years after it occurs, regardless of whether the policy is then in effect. In addition, the insured organization should be required to advise the appropriate administrator promptly upon making a claim under any insurance policy.

8.39 No proposals for insurance coverage are made in this section concerning the contractual plan service companies discussed in paragraphs 7.45 to 7.54. We think it important that such companies be adequately insured, but have concluded that it would be preferable for the nature of the applicable requirements to be determined in the formulation of conditions subject to which an exemption would be granted as proposed in paragraph 8.62.

8.40 For the reasons set out in this section, we recommend:

(1) that mutual funds, their management companies and their distribution companies should maintain on file with the appropriate administrator a certified copy of a resolution or other evidence to establish that detailed consideration had been given to the necessary amount of insurance coverage by the board of directors or equivalent body; in the case of an unincorporated mutual fund without such an equivalent body, the board of directors of the management company would serve the purpose. In the event that the board of directors or other body concludes that insurance coverage greater than that contemplated by the following recommendations is necessary, the resolution or other evidence should state in detail the limits decided upon, and such limits should be the minimum limits to be adhered to by that organization until an amending document is filed with the appropriate administrator;

(2) that fidelity insurance or bonds should be maintained on directors, officers and employees of the mutual fund, management company and distribution company in amounts not less than those required under the following rules:

(a) on each person authorized to sign cheques drawn against bank accounts maintained pursuant to paragraph 8.24, recommendation (6), clause (a), in an amount equal to that specified in the mutual fund prospectus as the maximum total amount to be deposited in such accounts, but in no event less than $150,000;

(b) on each person authorized, alone or together with one or more other persons, to give instructions concerning the delivery of assets of the mutual fund, in the amount of $600,000 where the mutual fund concerned, alone or together with other mutual funds under common management with it, has total net assets in excess of $5,000,000; and in the amount of $250,000 in other cases;

(c) on each other person who from time to time has access, as a messenger or in a clerical or similar capacity, to assets of the mutual fund, in amounts equal to one-half of the amounts specified in clause (b); and

(d) on all directors, officers and employees of the mutual fund, management company and distribution company other than those covered by the preceding clauses, in the amount of $100,000;

Where two or more of the preceding clauses are applicable to the same director, officer or employee the applicable minimum coverage should be the highest amount specified by such clauses;

(3) that the appropriate administrator should have power to require an increase in the insurance coverage of any registered mutual fund, management company, distribution company, independent sales force or broker; such power could be exercised upon a finding by the administrator that the insurance then in force does not provide adequate protection;

(4) that the mutual fund, management company or distribution company, as appropriate, should maintain insurance against the risks specified in classes B, C, D and E in the footnote to paragraph 8.35; such insurance where the mutual fund concerned has total net assets, alone or together with other mutual funds under common management with it, in excess of $5,000,000 should be not less than $600,000 with respect to the risks described in classes B and C, and not less than $250,000 with respect to the risks described in classes D and E; corresponding amounts in other cases should be $250,000 and $100,000, respectively;

(5) that each insurance policy issued in compliance with recommendations (1) to (4) should contain provisions specifying:

   (a) that no cancellation or amendment by either party shall be effective unless and until fourteen days' prior written notice of such cancellation or amendment is given to the appropriate administrator; this would include any reduction in coverage made pursuant to an amendment of the resolution or similar document referred to in recommendation (1); and

   (b) that the protection provided by the policy will be available for a loss resulting from an insured risk if the loss is discovered within two years after it occurs, regardless of whether the insurance policy is then in effect;

(6) that each organization which maintains insurance in compliance with recommendations (1) to (4) should be subject to a statutory obligation to report forthwith to the appropriate administrator any claim made under any such policy;

(7) that recommendations (1) to (6) should be implemented by being embodied in regulations rather than legislation to facilitate expeditious change and should be kept under continuing review by the appropriate administrator; and

(8) that insurance requirements applicable to contractual plan service companies should be determined in the formulation of conditions subject to which an exemption would be granted pursuant to paragraph 8.64, recommendation (12).

Custody of Mutual Fund Shares or Units

8.41 Many distribution companies, including most of those which engage in extensive sales operations, provide facilities to retain in custody shares or units purchased from or through them. Such facilities are made available both as a convenience to investors and to simplify the administrative operations of the distribution companies. Each objective is a

desirable one, and we accept that custodial arrangements of this type can often be a considerable convenience for all concerned. Particularly after the implementation of our proposal in paragraphs 13.72 to 13.78 for the prohibition of secondary markets, any liquidation of mutual fund shares or units would almost invariably be effected through redemption rather than through sale to a third party. There is, then, little need for the investor to have a share certificate or similar document as evidence of his title. It must, however, be recognized that the organization which acts as custodian assumes responsibilities the proper performance of which is essential for adequate investor protection.

8.42 The principal matters which require consideration in connection with the custody of mutual fund shares or units are different from those dealt with in preceding sections in connection with the custody of assets of the mutual fund. In the latter context, safekeeping of the documents which represent title to the various assets is of great importance; with the custody of mutual fund shares or units, safekeeping is of less importance than precision of records. In many cases, no actual document is issued to represent the shares or units held in custody, since administrative necessity dictates more expeditious handling of transactions than would be consistent with the issuance of such a document.

8.43 The problems involved in the custody of mutual fund shares or units are the same whether the distribution company itself acts as custodian or delegates that function to an outside organization. The exact arrangements followed are affected, in the case of incorporated mutual funds, by legal requirements concerning registrars and transfer agents. We have concluded that, except in the case of contractual plans, the distribution company should be permitted to act as custodian for the beneficial holders of mutual fund shares or units, but that the review procedure in such cases should be at least as rigorous as that applied where a separate organization so acts. In cases where a separate custodian is appointed, it need not be required to satisfy capital or other requirements, again except in the case

of contractual plans; with that exception, any organization legally qualified so to act should be permitted to be a custodian of shares or units.

8.44 In any case where a distribution company, broker or independent sales force establishes an arrangement under which it or a custodian designated by it is to hold shares or units sold (or received on the reinvestment of dividends, or both) and effects sales on that basis, we have concluded that complete information concerning the arrangement should be filed with the appropriate administrator before sales are made under it, or forthwith after the enactment of the legislation if the arrangement is then in effect. Such information should include a copy of the custodial agreement when an organization other than the distribution company is to act as custodian, or a copy of the declaration of trust or other document which sets out the terms upon which the distribution company will itself act as custodian. In either event, complete information concerning the record-keeping procedures to be followed should be supplied; if electronic data processing equipment is to be used, the description should include a review of verification procedures and of the extent to which written information concerning transactions is available to supplement the electronic records. All material so filed should be kept current through the prompt filing of amendments to agreements and of descriptions which reflect material changes in procedures.

8.45 We have considered whether the nature of the books and records kept by the custodian of shares or units should be prescribed by regulation. Our conclusion is that such a regulation is not immediately needed, and that the industry practice may establish a sufficiently high standard that it will remain unnecessary. The legislation should, however, provide authority for the passage of such a regulation at a later date. If that authority is exercised, the information contemplated by the preceding paragraph should establish compliance with the resultant regulation.

8.46 The only instances in which the administrator should have the opportunity to consider record-keeping procedures before custodial arrangements are implemented are cases where the shares concerned are to be purchased

under a contractual plan; this is dealt with in paragraph 8.55. Implementation of other types of custodial agreements should be permitted immediately on delivery of the relevant material to the administrator. However, the administrator should have the right to inspect all books and records relevant to custodial arrangements for shares or units. If he should find in any case that procedures or record-keeping arrangements are inefficient or inadequate, he should have authority to suspend the further sale of shares or units under those custodial arrangements until the problems are resolved, or to require the distribution to the persons beneficially entitled of the shares or units held in custody. These powers would, we anticipate, be rarely exercised; instead, when deficiencies are found in the procedures followed, the administrator would discuss the matter with the persons concerned in order to arrive at appropriate procedural changes.

8.47 Implementation of the requirements outlined in preceding paragraphs would significantly increase the quality of protection available to investors whose shares or units are held in custody, but would not resolve all the questions involved in such arrangements. One important question concerns the fees paid for the custodial service. In paragraph 10.119 we propose that a maximum limit should be imposed on service charges payable under contractual plans. We have concluded that, with this exception, no substantive restrictions are necessary on the fees charged for the custody of mutual fund shares or units.

8.48 The custodian of mutual fund shares or units should have no lien or other claim against the shares or units held in custody, except to the extent of any claim for payment of service fees specifically contemplated by the relevant contract; nor should the custodian have authority to encumber such shares or units as security for obligations of the custodian. This is an important principle, and should be implemented either through a requirement that the necessary provisions be included in the custodial agreements

or, preferably, by a statutory provision which restricts the rights of creditors of the custodian. Such a provision would not be practicable with respect to the assets of the mutual fund because of the variety in types of assets, but there would be no difficulty in its specific application to shares or units of the mutual fund.

8.49 Suggestions have been made to us that we should propose the enactment of a regulatory scheme concerning the exercise of voting rights attached to shares or units held in custody. Problems such as those which arose during the Commonwealth-Channing proxy battle, alluded to in paragraph 6.20, are advanced to support the need for such a scheme. We have concluded that a regulatory scheme concerning voting rights should relate only to the limited range of matters upon which we propose that all shareholders or unitholders should be given the right to vote, as indicated in paragraphs 6.45 to 6.58 and elsewhere in this report. It is, we feel, unnecessary to prescribe a regulatory scheme concerning votes on matters as to which the right to vote is not required by statute.

8.50 On those matters concerning which a vote of shareholders or unitholders is required, we have concluded that the applicable legislation should specify that custodians must provide the right to vote to persons beneficially entitled to shares or units held in custody. The legislation should also require the custodian to send copies of the relevant material concerning any pending vote on a matter as to which a vote is required, to those persons shown by its records as the beneficial owners of shares or units held in custody, and to provide them with a reasonable opportunity to give instructions concerning their votes. Instructions received from such holders should be binding. The custodian could act as proxy, but should not be permitted to exercise the voting power attached to shares or units held in custody without specific instructions from the beneficial holders of such shares or units. The absence of provisions such as proposed in this paragraph could negate the value of requirements for a vote.

8.51 For the reasons set out in this section, we recommend:

(1) that subject to paragraph 8.64, recommendation (1) concerning custodial agreements for contractual plans, and subject to the following recommendations, either the distribution company or any other legally qualified organization should be permitted to act as custodian for shares or units sold;

(2) that any organization engaged in the distribution of mutual fund shares or units which establishes an arrangement under which it or a custodian designated by it is to hold shares or units sold (or shares or units received on the reinvestment of dividends paid on shares or units sold) and effects sales on that basis, should file with the appropriate administrator a copy of the custodial agreement or of the declaration of trust or other document which sets out the terms of the custody together with complete information concerning record-keeping procedures followed or to be followed; if electronic data processing equipment is to be used, such information should include a review of verification procedures and of the extent to which written information concerning transactions is available to supplement the electronic records; all material so filed should be kept current through the prompt filing of amendments to agreements and of descriptions which reflect material changes in procedures;

(3) that subject to paragraph 8.64, recommendation (1) with respect to contractual plans, custodial agreements could be continued or commenced after the filing proposed by recommendation (1) without the consent of the administrator being necessary;

(4) that the legislation should provide for the passage, by regulation, of requirements concerning the books and records to be maintained by the custodians of mutual fund shares or units; if such requirements are passed, the information filed pursuant to recommendation (2) should establish compliance with such requirements;

(5) that the appropriate administrator should have the right to inspect all books and records relevant to custodial arrangements falling within recommendation (2) in order to assess the procedures and the quality of record-keeping; if he should find the procedures or the record-keeping to be inefficient or inadequate he should have the further power:

(a) to suspend the further sale of shares or units under these custodial arrangements until the problems are resolved, or

(b) to require the distribution of the shares or units held in custody to the persons beneficially entitled to them;

neither of such powers should be exercised unless it appears unlikely that the situation will be resolved through discussions with the persons concerned;

(6) that except for the payment of service fees specifically contemplated by the relevant agreement the custodian should have no lien or other claim against the shares or units held in custody; appropriate provision should be made to deny access to such shares or units on the part of creditors of the custodian. This could be accomplished through a requirement for the inclusion of necessary terms in the custodial agreement, or through direct statutory limitation of the rights of creditors; and

(7) that legislation which implements our recommendations in paragraph 6.59 and the paragraphs there referred to that shareholders or unitholders of the mutual fund should be given the right to vote on certain matters, should also specify that:

(a) custodians of shares or units may not vote them on such matters except on the direction of the beneficial owners;

(b) the custodian should send copies of the relevant material concerning any pending vote on such matters to the persons shown by its records to be the beneficial owners of shares or units held in custody, and should provide such persons with a reasonable opportunity to give instructions concerning their votes; and

(c) instructions received from the persons referred to in clause (b) should be binding on the custodian.

Special Requirements Applicable to Contractual Plans

8.52 In paragraph 7.46 we describe the reasons for our belief that the sponsor of a contractual plan should be recognized to assume a long-term commitment in favour of the planholder, and should therefore be subjected to requirements designed to ensure that it will be able to carry out that commitment. The prepayment of sales charges which is the basis of a contractual plan provides its recipient with a substantial advantage, and it is reasonable to expect that recipient to assume commensurate responsibilities.

8.53 The important rights of the planholder are to have his plan serviced, and to have payments invested in shares or units, in each case at the specified charge or fee. Each right is of considerable value; an increase in service charges while the plan is in effect could have an adverse impact, although implementation of our recommendations in paragraph 10.119 would restrict the possibility of abuse in this way by the imposition of a maximum service charge. The service charge should be the only compensation paid to the contractual plan custodian for his services. This restriction would not affect fees for reinvestment of dividends, services on redemption of shares or units, or similar matters not a necessary part of the contractual plan.

8.54 As the example given in paragraph 7.46 makes clear, the right to acquire shares or units at the specified sales charges is even more important to the purchaser than service charges, particularly in the later years of the contractual plan. If the right of the planholder to purchase shares or units at not more than the specified sales charge is to be satisfied, shares or units of the mutual fund must continue to be available, which means that it must remain in existence and qualified to sell. Continued existence of the mutual fund cannot be made certain, but implementation of our proposal in paragraph 7.47 that investments through contractual plans should be prohibited except for mutual funds with over $1 million in total net assets

should minimize the possibility that the mutual funds concerned will cease operations. That alone would not be sufficient protection for the planholder. In the following paragraphs we make proposals designed to ensure adequate performance of other aspects of the long-term commitment that is inherent in contractual plans. These proposals are in large part based on the relevant provisions of the Investment Company Act of 1940.

8.55 We have concluded that no contractual plan should be sold unless a properly qualified custodian agrees to service it. In paragraphs 8.11 to 8.14 we discuss the qualifications that should be satisfied by the custodian of a mutual fund's assets, and make proposals in that connection. We have concluded that the same requirements should be applicable to custodians of shares or units sold under contractual plans. These are, in brief, that the custodian should be an institution duly qualified to act in that capacity, subject to inspection by a governmental agency, and with an excess of capital over liabilities of not less than $500,000. A custodian satisfying these qualifications should be required to be appointed in any case where a contractual plan is offered, and should be obligated to perform under the contractual plan; the custodian should be prohibited from resigning unless replaced by a similarly qualified custodian which assumes all the obligations of the original custodian under the plan. Copies of the custodial agreement and of all amendments thereto should be required to be filed with the appropriate administrator. Agreements entered into prior to the effective date of the legislation could be continued in effect without the consent of the administrator. An agreement entered into after that date should not be implemented without the administrator's consent; before giving consent, the administrator should consider not only the matters discussed in this section but also the adequacy of the record-keeping procedures of the custodian.

8.56 All payments under a contractual plan should be made directly to the custodian and should be subject to the restriction on commingling proposed in paragraph 7.41. The custodian should deduct the service charge to which it is entitled, pay the appropriate sales or other charges in accordance with applicable arrangements, and invest the balance in the mutual

fund on behalf of the holder of the contractual plan. The shares or units so acquired would be held by the custodian as trustee for the planholder.

8.57 The proposals made in the preceding paragraphs would, in our opinion, adequately ensure that the services promised under the contractual plan were properly provided. They would not alone guarantee the continued availability of shares or units of the mutual fund. It is possible that following a transfer of the distribution and management contracts the transferees might wish to cease sales to the custodian. It is even conceivable that a distribution company might wish to cease such sales as a matter of business policy. We have concluded that before a contractual plan is made available to the public, arrangements satisfactory to the appropriate administrator should be established to ensure the continued availability of shares or units to the custodian. With an incorporated mutual fund, such arrangements might take the form of a contract between mutual fund and custodian, which the custodian would undertake to planholders that it would not amend to their detriment. With a trusteed mutual fund, appropriate provisions might be included in the trust agreement or declaration of trust, and further supported by a contract between the trustee and the custodian.

8.58 One problem would be left unresolved by the proposals made in the preceding paragraph. This is that the mutual fund might cease operations, or might not continue to be qualified for the sale of its shares or units. Either occurrence would obviously prevent completion of the plan as originally intended. We have concluded that provisions should be enacted to ensure fairness in these situations. First, prior to the issuance of contractual plans the custodian should obtain assurances from the management and distribution companies that they will exercise their best efforts to maintain the mutual fund in operation and to avoid a lapse in its qualification to sell shares or units during the life of the contractual plan. It should be a condition of any transfer of the management or distribution contracts as described in paragraphs 11.16 to 11.26 that renewals of these representations be obtained from the transferees.

8.59 The requirements proposed in the preceding paragraph should be supplemented by an obligation on the contractual plan sponsor to avoid loss to planholders if the mutual fund should cease operations, through liquidation or otherwise, or if its qualification to sell is terminated, in spite of the representations obtained. The contractual plan sponsor would be the organization which received the principal benefit of the excess sales charges paid in the early period. This would ordinarily be the distribution company, but in the case of plans serviced by contractual plan service companies it would be the broker or independent sales force which sold the plan. An obligation such as we suggest is presently assumed by some distribution companies. The prospectus of United Accumulative Fund Ltd. describes the obligation as follows:

> In the event that the Plan is terminated because Fund shares are no longer available for purchase, United will refund the sales charge deductions on investments made under the Plan to the extent that the percentage that such sales charge deductions bear to such investments made exceed the percentage that the total sales charge deductions would have been to the total investments made if the Plan had been completed.

It is possible that in some cases the qualification to sell of a mutual fund may be suspended for technical reasons and for a brief period. To allow for this possibility, the obligation here proposed should not become effective for ninety days after the qualification ceases.

8.60 In cases such as are contemplated by the preceding paragraph, it is possible that the contractual plan sponsor might be financially unable to satisfy the obligation suggested. The events which result in the unavailability of mutual fund shares or units might also result in insolvency of the contractual plan sponsor. The custodial agreement should specify that in such a case the custodian will endeavour to arrange for shares or units issued by a mutual fund with substantially similar investment objectives and practices to be acquired at a sales charge not in excess of the appropriate portion of remaining payments on the contractual plan. The custodian should then give to planholders the option to continue payments on their contractual plans, and to have those payments invested in that other mutual fund; accep-

tance or rejection of this option should have no effect on planholders' rights to previously purchased shares or units. Planholders who accept the option offered by the custodian should not be permitted to claim against the contractual plan sponsor pursuant to the statutory obligation proposed in the preceding paragraph.

8.61 If the responsible persons determine to wind up the mutual fund or to cause it to cease sales of its shares or units, they should be permitted to discuss the proposal with contractual planholders and to attempt to persuade them to accept an alternative approach to those outlined in the two preceding paragraphs. The custodian should also have power to propose an alternative approach to the holders of contractual plans. In either case, if the holders of contractual plans that represent in excess of 66-2/3% of the amount paid under outstanding plans accept the alternative approach, all planholders should be bound by it. In other cases, the procedures outlined in the two preceding paragraphs should be applicable.

8.62 Implementation of the recommendations made in this section might involve serious problems for the contractual plan service companies. Those companies presently in existence in Canada might be unable to qualify as custodians, or to find organizations qualified to assume such responsibilities. In addition, the distribution companies concerned might not co-operate with them in satisfying the proposed requirements. To prohibit these service companies from the issuance of new contractual plans might well make their continued operation impossible, thereby putting in jeopardy the rights of contractual planholders under outstanding plans. We have therefore concluded that the appropriate administrator should have power to exempt from the requirements suggested in this section contractual plans serviced by any contractual plan service company in operation in Canada at the time of passage of the relevant legislation, upon being satisfied that planholders were adequately protected. The exemption could be made subject to compliance with such conditions as the administrator thought fit. This specific exemptive power would in no way restrict the more general power proposed in paragraph 7.19.

8.63 The requirements suggested in this section should not be compulsorily applied to contractual plans outstanding at the effective date of the legislation, although some organizations may extend such rights to plan-holders voluntarily.

8.64 For the reasons set out in this section, we recommend:

(1) that the sale of a contractual plan, as defined in paragraph 10.125 recommendation (1), should be prohibited unless the contractual plan is serviced by a custodian which has the qualifications described in paragraph 8.24, recommendation (2); a copy of the custodial agreement and of all amendments thereto should be required to be filed with the appropriate administrator, and agreements entered into after the effective date of the legislation should not be implemented without the consent of the administrator; before giving consent, the administrator should consider not only the matters referred to in the following recommendations but also the adequacy of record-keeping procedures of the custodian;

(2) that the service charges paid to the custodian, under a contractual plan, which would be subject to a maximum limit under paragraph 10.125, recommendation (5), should be the only compensation paid to the custodian for its services; this restriction should not affect fees for reinvestment of dividends, services on redemptions of shares or units, or similar matters which are not a necessary part of a contractual plan;

(3) that the custodian should be subject to a statutory prohibition against withdrawal from his duties unless they are assumed by another custodian which satisfies the qualifications;

(4) that all payments under a contractual plan should be made to the custodian, which should receive them subject to the prohibition against commingling recommended in paragraph 7.44, recommendation (6);

(5) that the custodian should deduct from payments the agreed service charge for its own account, deduct and distribute sales charges in accordance with the plan, and invest the balance of each payment in mutual fund shares or units which it would receive as trustee for the planholder;

(6) that arrangements satisfactory to the appropriate administrator should be required to be made to ensure the continued availability to the custodian of shares or units while the mutual fund continues to exist and to be qualified for the sale of its shares or units, and while any contractual plan remains effective;

(7) that the custodian should be supplied with representations from the management company and the distribution company that they will use their best efforts to cause the mutual fund to continue to exist, and to continue to be qualified for sales of shares or units, while any contractual plan remains effective; and that no transfer of the management or distribution contracts as defined in paragraph 11.27, recommendation (2), should be permitted unless confirmation of such representations is obtained from the transferee or transferees;

(8) that in the event that the mutual fund ceases to exist or ceases for a period in excess of ninety days to be qualified to sell its shares or units, while any contractual plans remain effective, the contractual plan sponsor should, subject to recommendations (10) and (11), be required to pay to each planholder an amount equal to the excess of sales charges actually paid over what they would have been if the percentage deducted had been limited to what the percentage deducted as sales charges would have been, if the plan had been completed;

(9) that for purposes of recommendation (8) the contractual plan sponsor should be the organization which obtained the principal benefit of the excess sales charges described in that recommendation; in the

case of contractual plans sold by a distribution company it would ordinarily be the distribution company, and in the case of contractual plans serviced by a contractual plan service company it would ordinarily be the broker or independent sales force directly responsible for the sale of the contractual plan;

(10) that in the event the contractual plan sponsor is unable to make the payment described in recommendation (8), the custodian should endeavour to find another mutual fund with similar investment objectives and practices, shares or units of which can be acquired at sales charges not in excess of those deductible from remaining plan payments, and should then offer to continue to accept payments for investment in such mutual fund; a contractual planholder who accepts such offer should not be entitled also to enforce his claim pursuant to recommendation (8);

(11) that either the custodian or the persons responsible for the operation of the mutual fund should be permitted to propose an alternative to the procedures which would otherwise be required under recommendations (8) and (10); the alternative could be implemented for all holders of contractual plans if approved by holders who represent in excess of 66-2/3% of the amount paid in under all contractual plans;

(12) that the appropriate administrator should have power to exempt, subject to compliance with such conditions as he sees fit, contractual plans issued by any contractual plan service company in existence when the legislation becomes effective, from the operation of the preceding recommendations; and

(13) that recommendations (1) to (11) should not apply to contractual plans outstanding at the effective date of the legislation.

Inspections, Including Records and Surprise Audits

8.65 Regulatory systems often tend to weigh most heavily on the organizations for which they are least needed, namely those which are operated on an ethical basis and make it a policy to comply not only with the

letter but also with the spirit of applicable rules. Other organizations, those for which the regulations are often designed, might take a more cavalier attitude toward them; reliance on a strict interpretation of the letter of the law, by contrast with conscientious adherence to its spirit, can result in completely different methods of operation. Only by effective enforcement can the disparity be rectified. With regulations of the type proposed in this chapter, and with most of the recommendations in this report, effective enforcement can only be attained with an adequate system of inspection. Compliance with many of the procedures proposed in this report could be confirmed only by personal inspection, and problems in other aspects of operations can be detected in that way before they develop into crises.

8.66 The administrative authority responsible for the supervision of a financial institution is relied on to an increasing extent by public investors to prevent the dissipation of their money by fraud, theft or other risks not expressly or impliedly accepted by the investors. This task is as difficult as it is important: the very liquidity of the assets facilitates their rapid movement. If he is to carry out his obligations, the administrator must be given the necessary authority and the necessary support. In Chapter VI we consider various alternative techniques for the provision of continuing scrutiny, and are unable to arrive at a satisfactory technique for that purpose; this further accentuates the importance of the role of the administrator.

8.67 The appropriate administrator should have authority at any time to inspect the books and records of any of the organizations discussed in this chapter. This should be true not only of the mutual fund, management company, distribution company, independent sales force, broker and contractual plan service company, but also of the various custodians. The authority should be exercised by the administrator not only through such visits as are necessary to deal with problems as they arise, but also through a regular programme of inspections. If the relevant legislation is provincially administered, the various administrators concerned should co-operate to establish an effective inspection programme which will not involve unnecessary duplication for mutual

funds registered in more than one province. If it is nationally administered, the administrator should arrange a similar programme. While we strongly recommend the development of such a programme, it would be unrealistic to anticipate the immediate availability of resources sufficient for its development. It should instead be a goal attained over a period of time. The necessary delay in the implementation of a full inspection programme accentuates the importance of the only other inspection technique available, one which in our view ought properly to be supplementary to a regular scheme of inspection.

8.68 In paragraphs 6.69 to 6.87 we discuss the appointment of the mutual fund auditor and his responsibilities for reporting in connection with the annual financial statements of the mutual fund. While the discussion in those paragraphs is addressed to the responsibility owed by the auditor to the shareholders or unitholders, the recommendations made include a number of matters to be reported to the appropriate administrator. Implementation of those recommendations would significantly improve the value of the auditor's role in the regulatory scheme. But this is not the only responsibility that we think should be placed on the mutual fund auditor. As the only independent person, apart from the administrator and his staff, with access to the books and records of the mutual fund, the auditor can make a very valuable contribution by way of supplement to the inspection programme carried out by the administrator.

8.69 Early in 1969 the Canadian Mutual Funds Association adopted a requirment that the auditors of its members conduct an annual inspection and report on the results to a central audit committee. In its February, 1969 policy ruling* the Ontario Securities Commission accepted this principle and applied a substantially similar requirement to all mutual funds. We agree with the principle upon which these requirements are based, that the auditor of the mutual fund should be required to conduct an annual inspection on behalf of the appropriate administrator. Subject to the revisions proposed in the

* Ontario Securities Commission, Policy Statement on Conditions of Registration, February 17, 1969, as subsequently amended.

following paragraphs, we have concluded that the relevant provisions of the Ontario Securities Commission policy ruling reflect appropriate procedural arrangements and should provide the basis for the new regulatory scheme. They ought, however, to be kept under constant review so that they will reflect the lessons gained by experience.

8.70 The Canadian Mutual Funds Association requirement referred to in the preceding paragraph incorporates a detailed questionnaire to be completed by the mutual fund and certified by the auditor in connection with his inspection programme. We have concluded that this is a desirable provision, and that, subject to certain comments in the following paragraphs concerning its contents, it should be made part of the general requirements. The questionnaire should be kept under continuing review to verify that it requires a complete inspection of all matters likely to affect the mutual fund shareholder or unitholder. These include relevant aspects of the operations of the management company, the distribution company and the custodian of assets, as well as the mutual fund itself. In addition, we have concluded that the scope of the inspection should extend to the procedures followed on issuance and redemption of shares or units of the mutual fund, and to custodians of outstanding shares or units. Under the C.M.F.A. questionnaire procedures on issuance and redemption of shares or units need be inspected only if the transfer agent or registrar concerned does not deal at arm's length with mutual fund, management company or distribution company. These procedures are important regardless of the relationship of the transfer agent or registrar and the questionnaire should therefore be revised so that the auditor will review these matters in all inspection.

8.71 It could be contended that arrangements for the custody of outstanding shares or units are private matters to be resolved between the custodian and the beneficial owner of the shares or units, and are not properly within the scope of an inspection of the mutual fund. We accept this with respect to custodial agreements entered into privately by the shareholders or unitholders concerned. We do not accept it with the more usual type of custodial agreement, defined in paragraph 8.44, which forms part of the basis for the

sale of shares or units. In our view, the latter type of custodial arrangements, and all custodial arrangements for shares or units purchased under contractual plans, fall properly within the scope of the inspection procedure. We have therefore concluded that the C.M.F.A. questionnaire, which extends to custodial arrangements for mutual fund shares or units only where the distribution company itself acts as custodian, should be amended to require that the auditor verify the accuracy and adequacy of the procedures followed regardless of the identity of the custodian. His access to the necessary books and records should be guaranteed by statute.

8.72 It is very important for the inspection conducted by the auditor to be effected on a surprise basis. This is presently contemplated by the Ontario Securities Commission policy ruling, but not by the C.M.F.A. requirement; the latter should, then, be appropriately amended. The C.M.F.A. questionnaire is designed for completion at the time of preparation of the annual report, and revisions will be necessary to adapt it to surprise inspections. The appropriate administrator should have authority to determine when the surprise inspection will occur, and to instruct the auditor accordingly. The superiority of an inspection conducted on a surprise basis over one conducted by pre-arranged appointment is too obvious to require elaboration here.

8.73 Apart from the changes to the C.M.F.A. questionnaire required to implement the preceding conclusions, there is one other addition we think desirable. In paragraphs 6.84 to 6.86 we discuss the extent to which auditors may reasonably be expected to report on matters they regard as improper or illegal. For the reasons indicated in those paragraphs, we have concluded that in the report on his inspection the auditor should be required to report anything which has come to his attention that in his opinion may constitute evidence of an illegality, and permitted to report anything which has come to his attention that in his opinion may constitute evidence of an impropriety. Such provisions would encompass matters as to which no specific question was included in the questionnaire, or as to which the question included was not sufficiently precise to detect the suspected illegality or impropriety.

8.74 Under the C.M.F.A. requirement, reports are made to an accountant appointed by the C.M.F.A. as "industry auditor". This procedure is accepted by the Ontario Securities Commission in its policy ruling, although under that ruling the industry auditor is required to report on certain matters to the O.S.C. This arrangement should be considered and its continuance proposed in our discussion of self-regulation in paragraph 19.34.

8.75 The Ontario Securities Commission policy ruling contains detailed provisions as to the records which must be kept in connection with the operations of a mutual fund, management company and distribution company. In keeping with the policy adhered to throughout this report on the question of records, we make no specific proposals on this matter. The relevant legislation should include provision that would permit appropriate requirements to be adopted by regulation. This will enable the regulations to be designed so as to reflect changes in industry practice which may result from the implementation of this report. To ensure that adequate records are kept before the introduction of specific regulations, the legislation should require the organizations concerned to keep sufficient records to enable the auditor to certify all the replies in the questionnaire.

8.76 Contractual plan service companies are not presently registered with securities administrators, and are therefore not subject to inspection by them. We propose in paragraph 7.17 that their registration should be required. They should be subjected to an audit and inspection procedure at least as rigorous as that applied to mutual funds and their associated companies pursuant to the conclusions set out above, but the precise nature of the audit and inspection procedure can best be determined in the formulation of conditions subject to which they would be granted an exemption pursuant to paragraph 8.62.

8.77 While implementation of the suggestions in preceding paragraphs will be of considerable value in the regulatory scheme, we stress again that use of the mutual fund's auditor should be only supplementary to the inspection activities performed by the administrator and his staff. We trust that emphasis placed on the role of the auditor will not be permitted to obscure the importance of the latter type of inspection activity.

8.78 For the reasons set out in this section, we recommend:

(1) that the appropriate administrator should be given authority to inspect the books and records of any registered mutual fund, management company, distribution company, or contractual plan service company at any time; and should also be given authority to inspect the books and records of the custodians of assets of registered mutual funds and of custodians under custodial agreements referred to in paragraph 8.51, recommendation (2);

(2) that adequate staff and facilities should be provided to the appropriate administrator to permit the implementation of a regular inspection programme of all organizations referred to in recommendation (1); if the relevant legislation is provincially administered, the appropriate administrators should co-operate in the development and application of the programme;

(3) that the auditor of each mutual fund, appointed pursuant to the recommendations in paragraph 6.88, should be required to conduct an annual inspection and to report to the appropriate administrator concerning the results thereof. The rules governing such inspection should be based on the corresponding provisions contained in the Ontario Securities Commission policy ruling of February 17, 1969, supplemented by a form of questionnaire for completion by the mutual fund and certification by the auditor. The questionnaire would be based on that required by the Canadian Mutual Funds Association, but subject to the following:

(a) the rules and the questionnaire should require that the inspection include a review of procedures followed on the issuance and redemption of shares or units;

(b) the rules and the questionnaire should require that the inspection include a review of the custody of assets of the mutual fund and the custody of outstanding shares or units under custodial agreements referred to in paragraph 8.51, recommendation (2);

(c) the rules should require that the auditor conduct the inspection on a surprise basis, on instructions received from the appropriate administrator;

(d) the questionnaire should be adapted for use in connection with a surprise inspection; and

(e) the questionnaire should require the auditor to report to the administrator anything which has come to his attention that may, in his opinion, constitute evidence of an illegality, and permit him so to report anything which has come to his attention that may, in his opinion, constitute evidence of an impropriety;

(4) that the legislation should grant authority for the passage of regulations with detailed requirements concerning books and records to be kept by mutual funds, management companies and distribution companies; the legislation should specify that the books and records kept be sufficient to enable the auditor to certify the questionnaire referred to in recommendation (3); and

(5) that procedures at least as rigorous to those contemplated by recommendations (3) and (4) should be formulated for application to contractual plan service companies in the formulation of conditions subject to which an exemption would be granted pursuant to paragraph 8.61, recommendation (12).

CHAPTER IX

TRANSACTIONS MOTIVATED BY CONFLICTS OF INTEREST

9.01 In the introductory paragraphs of Chapter VI we discuss various types of risk to which the mutual fund may be subject, apart from those attributable to investment decisions made in good faith. Of these types, the most difficult problems are posed by investment decisions which are motivated by considerations other than the best interests of the mutual fund. The investment manager accused of causing the mutual fund to implement a transaction in order to benefit him or his company rather than to benefit the mutual fund can, except in the most flagrant situations, defend the transaction as a valid investment decision. Yet it is apparent that the investment manager or management company which is so inclined is in an excellent position to obtain benefits from mutual fund transactions, in any of a multitude of ways. This possibility and the legislation appropriate to avoid it are discussed in this chapter, together with the closely related topic of insider trading. The various potential abuses considered in this chapter all arise from conflicts of interest.

9.02 Control of potential abuses arising from conflicts of interest is a perennial topic of discussion because of its intrinsic importance and because it presents a host of difficult value judgments each of which requires that the scope of what is desirable be weighed against an assessment of what is workable in practice. It may be that in the ideal world affairs would be so conducted that no person would ever be in a position where his interest conflicted with his duty. We do not live in such a world, and it seems unlikely

that we ever will; it is therefore necessary to accept the existence of at least some conflicts of interest, and to determine the manner in which they may best be limited and controlled.

9.03 Organized society operates in large part through arrangements whereby the many delegate to the few responsibility for the conduct of some aspect of the affairs of all. This is the essence of government; of business organizations; and of almost every other kind of association. In all these situations a constant tension exists between the desire to control those entrusted with responsibility in order to prevent them from succumbing to conflicts of interest, and the desire to provide them with maximum discretionary power in order that a flexible policy may be pursued in the best interests of all concerned. This tension increases with the number of persons who delegate responsibility, and with the scope and importance of the delegation. It has rarely been satisfactorily resolved.

9.04 Legislatures and courts have long been aware of the problems created by conflicts of interest, and have tried to deal with them through a determination of whether impugned transactions satisfy a statutory standard of conduct. The nature of this standard differs between situations; it may be the fiduciary standard of a trustee, the fiduciary standard of a corporate director, the requirement that an employee serve his employer, or the civil law standard of the prudent administrator. Under existing law, any or none of these standards might be applicable with respect to actions taken by the management of a mutual fund, depending upon the form of organization of the mutual fund and upon the position in that organization of the individuals concerned. This means that significant differences exist in the legal responsibilities to which persons responsible for mutual fund management are subject.

9.05 In the introductory paragraphs of Chapter VI we explain why we believe the problems considered in that chapter, Chapters VII and VIII and this chapter to be worthy of special attention in the context of mutual funds although they may be said to be present to some extent with any public company. That explanation is relevant here, but there is an additional reason why prob-

lems of conflicts of interest deserve special attention in the context of mutual funds. This arises from the differences between the mode of compensation of senior management of mutual funds and that of other public organizations. In most industrial companies, a considerable portion of the reward to the senior managers is derived from their direct interest in the enterprise. Often they will hold a large number of shares; in many cases they are granted options for the purchase of shares at fixed prices over a period of time. In either event, they derive a direct benefit from the success of the organization and have less incentive to take actions inconsistent with the best interests of shareholders generally. In the mutual fund situation, on the other hand, it is less frequent for managers to look to the success of the mutual fund to generate their compensation. Options on shares or units have been infrequent in the past and we recommend their abolition in the future for the reasons indicated in paragraph 5.60. Large holdings of shares or units by senior managers are comparatively infrequent, and even where they exist they rarely form the major asset of individuals concerned. The principal reward of the senior managers is derived from management fees or sales charges, and while these may be affected by the performance of the mutual fund the connection is less direct than is true with an industrial company manager who benefits directly from an increase in value of his company's shares. This might be expected to increase the susceptibility to conflicts of interest of the mutual fund manager.

9.06 It should be emphasized that the considerations advanced in the preceding paragraphs are not meant to imply that transactions designed to benefit management rather than the mutual fund are prevalent or even frequent in the Canadian industry, although as the next paragraph indicates, they do occur. In the United States, the Investment Company Act of 1940 was preceded by a study that established abuses to be wide-spread, particularly among closed-end investment companies. At the beginning of our work as a committee we decided that an investigation of the scope and nature that preceded passage of the 1940 Act was not necessary. No allegations had been made that practices similar to those found to exist among investment companies in the United States

during the 1930's were present on a wide-spread basis in the Canadian mutual fund industry; those of us who are securities administrators and other provincial securities administrators not members of the Committee, were aware of some transactions that might be criticized, but believed that the incidence of transactions designed to benefit management rather than the mutual fund was so low that it did not constitute a major problem of the industry. While for this reason we did not conduct an inquiry into this specific question, we have studied other aspects of industry operations and have accumulated much information concerning them. Nothing we have ascertained during the course of this study has changed our opinion concerning the degree of incidence of self-serving transactions.

9.07 Our opinion that self-serving practices are not prevalent in the Canadian mutual fund industry has not led us to conclude that no controls are necessary in this area. The considerations outlined above establish at least the potentiality for acute conflicts of interest. We are aware of several specific situations which, although not representative of wide-spread practices, have caused us considerable concern. In at least two cases management has caused a mutual fund to invest in securities of other companies associated with management in transactions that we find difficult to accept as motivated by sound investment policy from the viewpoint of the mutual fund. In large numbers of cases mutual funds have purchased securities underwritten by associated brokerage firms, and while we cannot conclude in any specific instance that the purchase was not motivated by sound investment policy we regard such transactions as particularly susceptible of abuse. Finally, the importance of provisions to deal with conflicts of interest is increased by our conclusion in Chapter VI that there is no feasible technique available whereby those responsible for the operation of the mutual fund can be subjected to continuing scrutiny by the shareholders or unitholders or by a surrogate on their behalf.

9.08 Reference is made in paragraph 9.04 to the fact that the courts and legislatures have evolved standards of conduct designed to control conflicts of interest. In the next section of this chapter we comment on the

deficiencies of such standards, and on the three principal problems to be resolved by legislation in this area. We then consider the approach adopted in the 1940 Act with respect to these three problems. Finally we set out our own recommendations concerning each problem, considering them in separate sections. In the concluding section of the chapter we discuss the specific problem of controls over trading by mutual fund insiders on the basis of confidential information.

Adequacy of Existing Rules Controlling Conflicts of Interest; Questions to be Resolved

9.09 We do not propose here to set out a description of the various tests presently embodied in the civil and in the common law and designed to control conflicts of interest. To do so would require a complete textbook which could add little to material already available. A number of Canadian commentators, including governmental committees, have commented on these rules in the past few years and have uniformly found them deficient.* The deficiencies involve the definition of transactions which are to be regarded as abusive; the remedies to be applied when such transactions are detected; and procedures to facilitate disclosure of transactions that may fall within the definition. These three problem areas are discussed in the following three paragraphs.

9.10 In paragraph 9.04 we indicate that there is a considerable degree of variety in the nature of the standards applied under existing law to the managers of mutual funds. If the mutual fund is incorporated, certain comparatively rigorous fiduciary standards apply to its directors. Somewhat different standards apply to its officers or employees who are not directors, and the standards applicable to the management company, which usually has the effective decision-making power, may differ from either of these. If the mutual fund is organized as a trust, very different legal considerations apply. Not only is this diversity of standards undesirable, but the standards are themselves inadequate. The Interim Report to the Ontario Legislature of its Select Committee on Company Law, referred to in the footnote to paragraph 9.09,

* Examples include: Ziegel (ed.), Studies in Canadian Company Law (1967) 102 and 207; Select Committee on Company Law, Interim Report, Toronto: Legislative Assembly, 1967.

contains a discussion of the deficiencies in the standards applied to corporate directors. Similar remarks could be made with respect to each of the other general standards. Most have been judicially evolved and, while desirable so far as they go, are not designed to take into account the complexities of modern corporate and business life. A definition of abusive transactions must be formulated which is capable of application to mutual funds generally, however organized, and is adequate to deal with the range of problems that may arise. This problem is discussed in paragraphs 9.18 to 9.31.

9.11 The remedies to be applied when abusive transactions are detected involve two problems: substantive remedies and enforcement. The substantive remedies must be so designed as to deal with the wide variety of transactions that may occur, and to do so in such a way that the shareholder or unitholder will not suffer more from the remedy than from the abuse. Enforcement procedures must resolve the difficulties attendant upon the fact that this type of litigation is notoriously difficult so that a major financial commitment is involved in the commencement and continuance of proceedings. The scope of this commitment is augmented by the practice that prevails in Canada, unlike the United States, whereby the losing party in judicial proceedings is ordinarily required to pay the court costs and most of the legal expenses incurred by the successful litigant. In addition, lawyers in Canada may not accept cases on a contingency basis, an ethical restriction that we regard as desirable but which may further reduce the number of questionable transactions that are in fact challenged. All of these problems are considered in paragraphs 9.33 to 9.40.

9.12 However sophisticated a definition of abusive transactions may be, it is of no value unless questionable transactions are somehow brought to the attention of persons who may be prepared to take appropriate proceedings against them. This involves disclosure, a constant theme of this report that here arises in one of its most difficult aspects. An otherwise perfectly acceptable transaction may be subject to question for a variety of reasons. The most obvious such reasons, but by no means the only ones, are the relationship between the parties involved; the price paid or received; service or agency

fees paid; or the fact that the transaction facilitates a related transaction effected or to be effected by an officer or director. It is obviously not feasible to require wide-spread dissemination of information concerning every transaction effected by a business organization in sufficient detail to permit any of these types of abuse to be detected. In this context some of the usual approaches to the implementation of a disclosure requirement must therefore be reconsidered. This is done in our discussion of this problem in paragraphs 9.42 to 9.46.

<u>The Investment Company Act of 1940 -</u>
<u>The United States Approach</u>

9.13 In the United States, the second problem considered in the preceding section, that of costs, is not as major a consideration as in Canada. The unsuccessful litigant is not ordinarily required to pay the costs of the other party to the proceedings, and the contingent fee is permitted. Accordingly, the 1940 Act does not deal specifically with this problem. It does embody detailed provisions relating to each of the other problems discussed in the preceding section, provisions that are comparatively rigorous in recognition of the very serious abuses found to exist by the study which preceded passage of the Act. The philosophy and objectives of these provisions are well reflected by the preamble to the legislation, which includes a declaration that

> the national public interest and the interest of investors are adversely affected - ...
>
> (2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders; ...*

9.14 It seems appropriate to review the relevant provisions of the 1940 Act, since they embody a method of approach to the problems here being considered that has proven satisfactory in the opinion of the Securities and Exchange Commission, the responsible administrative authority. The following

* Investment Company Act of 1940, Sec. 1 (b)(2).

discussion draws heavily on a memorandum prepared for us by Mr. Milton Kroll and Professor Louis Loss, although space limitations necessitate a comparatively brief summary. It should be noted that the 1940 Act includes relevant provisions in addition to those with which we are here concerned. The most important of such provisions are those for unaffiliated directors, discussed in paragraphs 6.31 to 6.44.

9.15 Most of the provisions in the 1940 Act designed specifically to deal with conflicts of interest rely heavily on the definition of the phrase "affiliated person" contained in that Act, a definition set out in paragraph 6.37. In the following discussion of the 1940 Act provisions, we use the word "affiliate" instead of "affiliated person". Some of the provisions extend to transactions involving the affiliate of an affiliate. In view of the fact that affiliates of a particular company are defined to include, but are not limited to, persons who hold 5% or more of its voting securities, and companies of whose voting securities it owns 5% or more, it will be readily appreciated that the net of "affiliate of an affiliate" is cast very far. Even the concept of affiliation, without extending it to an affiliate of an affiliate, can sometimes encompass a large number of companies with some of which the investment company in question has virtually no connection. This approach presumably represents a value judgment on the part of the Congress of the United States to the effect that the importance of an adequate resolution of abuses was so great as to justify the enactment of a provision that might be unduly wide, in order to be certain that it would encompass all self-dealing transactions.

9.16 In the provisions with which we are here concerned, the 1940 Act embodies specific prohibitions rather than a generally applicable standard in its definition of the types of transaction subject to question. A mutual fund in the United States is also subject to the relevant provisions of the laws of its state of organization, and such laws ordinarily embody a general standard of responsibility; in addition, another provision of the 1940 Act subjects directors and officers to liability for gross abuse of trust. The specific prohibitions included in the legislation relate, in brief, to: the purchase of underwritten securities if any officer, director, member of an

advisory board, investment advisor, or employee of the mutual fund, or any affiliate of any of them, is a principal underwriter of the issue; the purchase of securities from, the loan of money to, or the sale of securities to, an affiliate; the entry into a joint transaction with an affiliate or the affiliate of an affiliate; and the payment to an affiliate or the affiliate of an affiliate, of compensation (apart from a regular salary), on the purchase or sale of property by the mutual fund, except that where the affiliate or affiliate of an affiliate is a broker he may be paid not more than the usual and customary commission if the transaction is effected in the course of his business as such. This summary statement of the classes of proscribed transaction gives an indication of their extent and of the careful fashion in which the legislation was prepared so as to encompass all types of self-dealing transactions.

9.17 The problem of disclosure of questionable transactions is resolved through the use of the Securities and Exchange Commission as a surrogate. Transactions falling within the defined classes referred to in the preceding paragraph may not be implemented without an exemption from the S.E.C. Exemptions may be granted pursuant either to rules of general application, or to orders made in specific cases. The general power has been used in the promulgation of regulations dealing with certain classes of cases; perhaps the most important of these is one that specifies the circumstances in which a purchase of underwritten securities may be made although a principal underwriter of the issue is an affiliate of the mutual fund. A mutual fund that proposes to implement a transaction which is prohibited by the relevant provisions, and for which no exemption is available under the regulations of general application, must obtain an exempting order from the Securities and Exchange Commission or abandon the transaction. It is of interest to quote the remarks made by Mr. Kroll and Professor Loss on the procedures in this connection:

> In practice, the consideration of interpretative question relating to, and the consideration and processing of applications for, exemptive orders under this statutory pattern have been among the principal activities of the S.E.C. in its regulation of investment companies. Customarily, preliminary discussions as to the application of one of the statutory prohibitions and the availability of an exemption are discussed informally with the S.E.C. staff.

When it is determined that a statutory bar to a transaction applies, the staff will indicate whether or not it will oppose an application for exemption. Generally staff opposition is tantamount to refusal, although the applicant is, of course, free in any case to file the application and go through a quasi-judicial, contested hearing before a hearing examiner. The ultimate decision is made by the Commission. In most instances, time requirements alone render it impractical to contest the staff's position, particularly when the problem relates to matters such as purchase during an underwriting or similar questions.

Even when the staff agrees that an exemption should be granted; the procedure is rather time-consuming. A formal application, which usually is reviewed informally by the staff in advance, must be filed and notice . . . is published. There is a minimum twenty-day waiting period between the date of filing and disposition of the matter by order. The notice invites any interested person to request a hearing. If no one requests a hearing during the twenty-day period, the Commission acts on the application and staff recommendation. If a hearing is requested, the procedure noted above is followed.

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Obviously, this administrative procedure requires the services of a large and relatively able staff in view of the volume and complexity of the problems involved. In the fiscal year ended June 30, 1966, 213 applications were filed with the S.E.C. under various sections of the Act, of which 183 were disposed of and 100 were pending at the year-end. Of the 213, 20 relating to Section 17 exemptions [Section 17 contains the relevant provisions except the one relating to underwritings] were pending at the start of the year; 48 were filed during the year, 48 were closed and 21 were pending at the end of the year. Only a very small number of applications (3) were filed under Section 10(f). [The Section containing provisions relating to underwritings]. This is due to the fact that in December, 1958, a conditional exemptive rule was adopted under this section with specified guidelines for exemption.

The volume of applications under Sections 10 and 17 in fiscal 1967 was about the same. There were 70 pending applications under Section 17, of which 49 were filed during the year under that section, 46 were closed and 24 were open at year-end. The statistics as to volume of applications do not tell the full story of the time and attention involved in these matters. The staff screens out and discourages some applications; others are revised considerably after staff conferences.

Because of the heavy reliance on staff for resolution of these problems and the need for consistency and uniformity, it is questionable (at least in the United States) whether such a statutory exemptive apparatus would be at all feasible if the regulatory and exemptive powers were not vested in a single, national authority.*

The remarks set out in this quotation had a considerable influence on the formulation of the recommendations discussed in the following three sections.

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* Kroll and Loss, Self-Dealing Prohibition in Mutual Fund Legislation. A report to the Canadian Committee on Mutual Funds and Investments Contracts, (Cambridge and Washington, 1968) page 4 (footnotes omitted).

Prohibited Transactions and Standards of Responsibility

9.18 The first problem to be resolved in the regulation of conflicts of interest is the definition of transactions that are to be regarded as abusive. We regard the standards embodied in existing legislation and case-law as inadequate, and we have concluded that a standard applicable with respect to all mutual funds should be embodied in legislation. The difficulty is to determine the nature of the standard, and its manner of application. A variety of alternatives are available. The standard could take the form of precise definitions of prohibited transactions, as in the 1940 Act, or could be a general statement of responsibility, or some combination of these approaches. Between these approaches an entire spectrum of alternatives is available.

9.19 There are two noteworthy precedents in Canada, although neither has become law at the time of writing. The first is a bill proposed for passage in Ontario, the Business Corporations Act, 1968, (introduced before the Legislature of Ontario on May 17, 1968 as Bill 125). The second is a series of bills proposed for passage federally.* The provisions of these bills provide examples of the alternative approaches described in the preceding paragraph. Bill 125 of Section 131 would provide that

> Every director and officer of a corporation shall exercise the powers and discharge the duties of his office honestly, in good faith and in the best interests of the corporation, and in connection therewith shall exercise the degree of care, diligence and skill that a reasonably prudent director or officer would exercise in comparable circumstances.

Supplementary provisions designed to resolve the problem of costs are referred to in paragraph 9.37. The bill contains no specific provision designed to force disclosure of transactions that may violate the quoted standard.

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* The bills are: The Investment Companies Act, Bill S-17; An act to amend the Canadian and British Insurance Companies Act, Bill S-35; An Act to amend the Trust Companies Act, Bill S-37; An Act to amend the Loan Companies Act, Bill S-38. Bill S-17 was introduced on November 12, 1968, and the other Bills on May 6, 1969. While Bill S-17 has been withdrawn for revisions, statements at the time of the withdrawal as to the sections to be revised did not refer to Section 8, with which we are here concerned.

9.20 Each of the bills proposed for passage federally would subject a class of financial institutions to a prohibition of certain types of investments. These provisions, to which we refer as the "federal self-dealing prohibition", are set out in a footnote.* They would apply to insurance compan-

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* The federal self-dealing prohibition as it appears in Bill S-17 is, with one major exception, virtually identical to the corresponding provisions in Bill S-35 (Section 8, amending Section 33 of the Canadian and British Insurance Companies Act); Bill S-37 (Subsection 25 (11), adding Section 68A to the Trust Companies Act) and Bill S-38 (Section 29, adding Section 60C to the Loan Companies Act). The major exception is that the latter three bills include a subsection referred to as the "downstream investment" provision which does not appear in Bill S-17. When reference is made in the text to the federal self-dealing prohibition, we intend the term to include the downstream investment provision. The latter three bills also include minor variations designed to relate their provisions to the classes of financial institutions affected by them. Because of the latter variations, we here set out the relevant provisions of Section 8 in Bill S-17, together with the downstream investment provision of Bill S-35.

(1) No investment company shall knowingly make an investment

(a) by way of a loan to

(i) a director or officer of the company, or a spouse or child of such a director or officer, or

(ii) an individual, his spouse or any of his children under the age of twenty-one years if either the individual or a group consisting of the individual, his spouse and such children is a substantial shareholder of the company;

(b) in a corporation that is a substantial shareholder of the company; or

(c) in a corporation in which

(i) an individual mentioned in sub-paragraph (i) of paragraph (a),

(ii) an individual who is a substantial shareholder of the company,

(iii) any corporation that is a substantial shareholder of the company, or

(iv) a group consisting exclusively of individuals mentioned in sub-paragraph (i) of paragraph (a)

has a significant interest.

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(3) For the purposes of this section,

(a) a person has a significant interest in a corporation, or a group of persons has a significant interest in a corporation if,

(i) in the case of a person, he owns beneficially, either directly or indirectly, more than ten per cent, or

ies, loan companies and trust companies subject to federal authority. They would also apply, under Bill S-17, to federally-incorporated companies that borrow money for the purpose of investment, except for companies subject to separate regulatory statutes such as insurance companies and banks. The defini-

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(ii) in the case of a group of persons, they own beneficially, either individually or together and either directly or indirectly, more than fifty per cent

of the capital stock of the corporation for the time being outstanding;

(b) a person is a substantial shareholder of a corporation, or a group of persons is a substantial shareholder of a corporation, if that person or group of persons owns beneficially, either individually or together and either directly or indirectly, equity shares to which are attached more than ten per cent of the voting rights attached to all of the equity shares of the corporation for the time being outstanding; and in computing the percentage of voting rights attached to equity shares owned by an underwriter, there shall be excluded the voting rights attached to equity shares acquired by him as an underwriter during the course of distribution to the public by him of such shares;

(c) "equity share" means a share of any class of shares of a corporation to which are attached voting rights exercisable under all circumstances and a share of any class of shares to which are attached voting rights by reason of the occurrence of any contingency that has occurred and is continuing;

(d) "investment" means

(i) an investment in a corporation by way of purchase of bonds, debentures, notes or other evidences of indebtedness thereof or shares thereof, or

(ii) a loan to a person or persons

but does not include an advance or loan, whether secured or insecured, that is made by an investment company to a corporation and that is merely ancillary to the main business of the investment company; and

(e) "officer" means the president, vice-president, secretary, assistant secretary, comptroller, treasurer and assistant treasurer of a corporation and any other person designated as an officer of the corporation by by-law or by resolution of the directors thereof.

(4) Where any person or group of persons is a substantial shareholder of an investment company and, as a consequence thereof and of the application of this section, certain investments are prohibited for the investment company, the Minister may, by order, on application by the investment company, exempt from such prohibition any particular investment or investments of any particular class if he is satisfied that the decision of the investment company to make or hold any investment so exempted has not been and is not likely to be influenced in any significant way by that person or group and does not involve in any significant way the interests of that person or group, apart from their interests as a shareholder of the investment company.

tion of investment company is more complicated than this brief description would indicate, but would not include mutual funds because they do not ordinarily borrow money. The federal self-dealing prohibitions reflect an approach somewhat similar to that of the 1940 Act, with an absolute prohibition of certain types of transaction unless an exemption is first obtained from the appropriate authority (in this case, the Minister responsible for administration of the legislation). The prohibited transactions would include investments by a company subject to the Act in, or loans by it to, individuals or corporations related to it in the manner described in the federal self-dealing prohibition. The individuals and corporations subject to the proscription include directors and officers of the investment company, and their spouses and children. They also include any individual who, either alone or together with his spouse and his minor children, owns 10% of the voting stock of the investment company; any corporation with that large a percentage of voting stock; and any corporation in which any of the foregoing owns more than 10% or any group of the foregoing owns more than 50% of the capital stock. Additional provisions encompass any corporation in which any of the foregoing owns more than 10%, or a group comprised of directors or officers of the company subject to the prohibition alone or together with their spouses or children owns more than 50% of the capital stock. A downstream investment provision, contained in all of the bills except Bill S-17, extends the companies in which investments may not be made to certain subsidiaries of companies caught by the preceding tests, on the basis of a complicated definition which relates to the percentage of ownership in the subsidiaries.

The following is the downstream investment provision which forms part of the corresponding section in Bill S-35.

(4) For the purposes of this section, where a person or a group of persons owns beneficially, directly or indirectly, or pursuant to this subsection is deemed to own beneficially, shares of a corporation, that person or group of persons shall be deemed to own beneficially a proportion of the shares of any other corporation that are owned beneficially, directly or indirectly, by the first mentioned corporation, which proportion shall equal the proportion of the shares of the first mentioned corporation that are owned beneficially, directly or indirectly, or that pursuant to this subsection are deemed to be owned beneficially, by that person or group of persons.

(5) Notwithstanding subsection (4), where a person or a group of persons owns beneficially, directly or indirectly, any shares of the capital stock of a company, that person or group of persons shall be deemed not to own beneficially any of the shares of any corporation that are beneficially owned or deemed to be beneficially owned by the company.

9.21 The three sets of legislative provisions described in the preceding section and in the preceding paragraphs of this section provide a good representation of the variety of approaches which may be adopted to deal with conflicts of interest. The 1940 Act imposes a wide but very specific prohibition of certain types of transactions which applies unless exemptions are obtained from the Securities and Exchange Commission as a surrogate for the investor. The federal self-dealing prohibition follows a similar approach, but defines prohibited transactions much more narrowly; under it, the Minister assumes a responsibility similar to that of the Securities and Exchange Commission under the 1940 Act provisions. Section 125 of the draft Business Corporations Act (Ontario) eschews the approach of the 1940 Act altogether, in favour of a general definition of the responsibility owed by a corporate director to his company.

9.22 In our consideration of an appropriate approach for adoption in Canada, we rejected the 1940 Act provision for two principal reasons. The first is that we concur with the statement in the last paragraph of the quotation set out in paragraph 9.17, that prohibitions as sweeping as these in the 1940 Act could only be feasibly administered on the federal level. The second principal reason is that even if national administration is available we do not think the 1940 Act provisions would be appropriate in Canada. The wide definition of "affiliate" and hence of "affiliate of an affiliate" is crucial to the provisions, but adoption of such definitions for a similar purpose in the smaller and more closely interwoven Canadian economy would result in an undue constraint on the investment activities of many mutual funds, particularly those which form part of large financial complexes. The federal self-dealing prohibition resolves this problem through the use of a definition that encompasses a narrower class of persons or companies as related, and by prohibiting only direct investments rather than the wider range of transactions caught by the 1940 Act provisions, which are summarized in paragraph 9.16.

9.23 We have concluded that the federal self-dealing prohibition would be workable even if administered on a provincial basis, but that because it is considerably narrower than the 1940 Act it would not alone be adequate to deal with problems of conflicts of interest in the context of mutual funds. It should be supplemented by an additional specific prohibition and by a general standard of responsibility similar to that in the draft Business Corporation Act (Ontario). These three would together constitute an adequate regulatory scheme. Their details are considered in the following paragraphs: the federal self-dealing prohibition in paragraphs 9.24 to 9.27, the additional prohibitions in paragraph 9.28, and the general standard of responsibility in paragraphs 9.29 to 9.31.

9.24 In the event that the federal self-dealing prohibition is revised prior to the final passage of the bills in which it is included, it would be desirable for legislation implementing our recommendations to embody similar revisions, if not inconsistent with our recommendations. In addition, there are certain changes that we think should be made in the provisions of the federal self-dealing prohibition for its effective application to mutual funds. The classes of persons or companies in which investments are not permitted should extend to those having the defined relationships with the management company or with the distribution company of the mutual fund, whether or not they also have the defined relationship with the mutual fund itself. They should also extend to companies in which the mutual fund has a major interest; specific recommendations on this point are made in paragraph 12.71. Technical changes would be necessary in order that the legislation could be applied to mutual funds organized as trusts or in other forms of organization rather than the corporate form.

9.25 Perhaps the most important changes that we think should be made in the federal self-dealing prohibition as applied to mutual funds relate to special situations that may fall within the spirit of the legislation but may not be encompassed by its precise language. We are concerned that the percentage figures used in that prohibition may be too high; a person could have

a major interest in a company with less than 10% of its voting shares, as could a group with less than 50% of the voting shares. Equally, there may be situations in which a company or person should not be included within the proscription although the specified percentage limits are satisfied. The crucial factual question in the determination of whether a particular person or company is associated with a mutual fund ought to be whether an investment in or a loan to him or it might result in a benefit, direct or indirect, to any person or company with the power to influence investment policy of the mutual fund. Should that be the case, the former person or company ought to be regarded as associated with the mutual fund; if that is not the case, the person or company ought not to be regarded as associated with the mutual fund.

9.26 In view of the considerations described in the preceding paragraph, we have concluded that the definition in the federal self-dealing prohibition of persons or companies in which investments, and to which loans, may not be made should be subject to the power of the administrator to rule that specified persons or companies do, or do not, fall within the definition regardless of its terms; this power would be wider than that of the Minister under the federal self-dealing prohibition. Either on his own motion or on application by an interested person, the appropriate administrator could declare either that a person or company not caught by the definition was associated with the mutual fund, or that a person or company caught by the definition was not associated with the mutual fund. In the latter case, the order could be made subject to compliance with such conditions as the administrator thought fit. The issue relevant to either type of order would be the question postulated in the preceding paragraph, and in either event the order could be conditioned to be effective only for a specified period or so long as specified facts remained unchanged. In the following discussion, the term "associates" is used to refer to the persons and companies caught by the proscription, either as encompassed by the definition or by reason of an administrator's order.

9.27 Legislation applicable to mutual funds should confer on the appropriate administrator an additional power, similar to that of the Minister under the federal self-dealing prohibition, to exempt classes of transaction by regulation, or specific transactions by order, from the compliance with specified conditions. A transaction or class of transactions should be permitted if it can be established either that they represent the business judgment of the responsible persons, uninfluenced by considerations other than the best interests of the mutual fund, or that the transaction is in fact in the best interests of the mutual fund. We have considered whether it would be feasible to confer this exemptive power, and that described in the preceding paragraph, on the courts in order to permit a single decision with national effect under a procedure similar to that described in Appendix D. We have concluded that this should not be done until that procedure has proven workable after an experimental period, but that the possibility of such an adjustment should be kept under continuing review if the relevant legislation is provincially administered. An appeal should lie in any event to the courts from an administrative decision applying these exemptions.

9.28 As indicated in paragraph 9.23, we have concluded that in the context of mutual funds the federal self-dealing prohibition should be supplemented by an additional, specific, prohibition. This would encompass every transaction in which an associate, as defined in paragraph 9.26, of the mutual fund received any fee or other compensation, apart from brokerage charges or fees paid pursuant to a contract clearly disclosed in the prospectus. Exemptive powers similar to those described above should be applicable with respect to this prohibition. We can conceive of few if any situations in which this prohibition will constitute a serious impediment to the implementation of desirable transactions, and there should be some restriction on the extent to which fees may be paid by mutual funds to associated companies pursuant to undisclosed arrangements.

9.29 The third part of the proposed regulatory scheme outlined in paragraph 9.23 involves the application of a general, statutory standard of responsibility similar to that contained in Section 131 of the draft Business Corporations Act (Ontario). This section is set out in paragraph 9.19, and would serve to catch abusive transactions which were so framed as to escape the specific prohibitions proposed in preceding paragraphs. Two questions must be resolved in its application to mutual funds: the statement of the standard, and the persons to whom the standard should apply. As to the first question, we have concluded that Section 131 as it applies to mutual funds should impose on those responsible for the management of a mutual fund an obligation to exercise their powers and discharge their duties honestly, in good faith and in the best interests of the mutual fund. The additional language contained in Section 131, which would require officers and directors to exercise the degree of care, diligence and skill that reasonably prudent officers or directors would exercise in the circumstances, is not necessary to deal with conflicts of interest.

9.30 The question of to whom the standard is applicable is one of considerable difficulty in the context of mutual funds as a result of the nature and variety of their organizational arrangements. With incorporated mutual funds, for example, the contracts under which the management and distribution functions are delegated to other organizations purport to reserve control in the board of directors, a reservation that would in any event be dictated by company law. The significance of the reservation varies from case to case; in paragraphs 6.13 to 6.30 we describe the Commonwealth-Channing proxy battle, one instance in which the board of directors of the mutual fund took an active role in management. On the other hand, in many cases advice received from the management company is implemented without question by the mutual fund. The latter situation is similar to that which ordinarily prevails with an unincorporated mutual fund, although in some cases the unincorporated mutual fund has a board of trustees independent of management.

9.31 We have concluded in view of the nature of our recommended statutory standard, which would impose no affirmative duty beyond a requirement that powers be exercised honestly, in good faith and in the best interests of the mutual fund, that the persons subject to it should include both those with the legal power or right to control the mutual fund, and those who in fact are able to do so. In an incorporated mutual fund, the board of directors would be included in the first category and in all cases the management company would be in the second category. Where doubt exists concerning what persons or organizations are subject to the standard, they could be resolved by a preliminary fact-finding at the outset of judicial proceedings arising from a particular transaction.

9.32 For the reasons set out in this section, we recommend:

(1) that, subject to the following recommendations, legislative provisions substantially similar to the provisions quoted in the footnote to paragraph 9.20,or to those provisions as finally enacted (if not inconsistent with the reasons for this recommendation as explained in this section), should be enacted for application to mutual funds, provided that:

(a) the persons and companies investments in which, or loans to which, are prohibited should be defined by reference to the management company and the distribution company of the mutual fund, as well as by reference to the mutual fund itself;

(b) the persons and companies referred to in clause (a) should also include companies in which the mutual fund has an interest, as recommended in paragraph 12.74, recommendation (3)(b);

(c) such technical changes as are necessary should be made to permit effective application of the section to mutual funds organized as trusts;

(2) that, for purposes of the following recommendations, the "associates" of a mutual fund are those persons or companies in which it may not invest, and to which it may not lend money, under the prohibitions here proposed;

(3) that the appropriate administrator should, subject to recommendation (5) and notwithstanding recommendation (1), have power to order:

(a) that a person or company was not an associate of a particular mutual fund; such order would be based on a finding that an investment in or a loan to that person or company would not result in a benefit, direct or indirect, to any person or company with the power to influence investment management of the mutual fund, and the order could be made subject to compliance with such conditions as the administrator thought fit; or

(b) that a person or company was an associate of a particular mutual fund; such order would be based on a finding that an investment in or loan to that person or company might result in a benefit, direct or indirect, to any person or company with the power to influence investment management of the mutual fund;

any such order could be made notwithstanding the scope of the definitions contained in legislation implementing recommendation (1), and could be conditioned to be effective only for a specified period or so long as specified facts remained unchanged;

(4) that, subject to recommendation (5) and notwithstanding recommendation (1), the appropriate administrator should have power to exempt a class of transactions by regulation, or a particular transaction by order, from the prohibitions contained in the legislation proposed in recommendation (1); such a regulation or order would be based on a finding that the class of transactions or the particular transaction represented the business judgment of the responsible persons uninfluenced by considerations other than the best interests of the mutual fund, or that the transaction is in fact in the best interests of the mutual fund; any such regulation or order could be made subject to compliance with such conditions as the administrator thought fit;

(5) that, if the relevant legislation is provincially administered, continuing consideration should be given in the light of experience under the procedure described in Appendix D to whether the court should have power, following a similar procedure, to make an order with national effect as to any of the matters contemplated by recommendations (3) and (4); the ordinary right of appeal should in any event be available from administrators' orders on such matters;

(6) that, in addition to the transactions contemplated by recommendation (1), a mutual fund should not be permitted to enter into any transaction in which an associate of the mutual fund will receive any fee or other compensation apart from brokerage charges or fees paid pursuant to a contract clearly disclosed in the prospectus; exemptive powers similar to those described in recommendations (3) and (4) should be provided from this prohibition;

(7) that those responsible for the management of a mutual fund should be subject to a statutory obligation to exercise their powers and discharge their duties honestly, in good faith and in the best interests of the mutual fund; and

(8) that, for purposes of recommendation (7), those responsible for the management of a mutual fund should include both those with the legal power or right to control it, and those who in fact are able to do so.

Remedies; Procedural Problems, Including Costs

9.33 It would be pointless to enact detailed provisions to define abusive transactions and a statutory standard of responsibility without including appropriate remedies for violations of ~~the~~ requirements. Yet such remedies may be difficult to define and to apply without causing the mutual fund investors additional harm. This difficulty can, in our opinion, best be dealt with through a wide grant of authority to the court, which will enable it to devise an appropriate remedy for transactions found to have contravened the statutory requirements. The diversity of possible situations is such that no

more specific remedy can be propounded with any certainty as to its adequacy. We have therefore concluded that where a court finds that a transaction constituted a violation of the statutory requirements, it should have power to determine a remedy appropriate to the particular case. It could order that the transaction be rescinded, with the parties returned to their original positions; that damages be paid; that an injunction issue prohibiting or restricting similar transactions in the future; or could grant other relief. Such an arrangement would be adaptable to any of the infinite variety of transactions that might be challenged.

9.34 Even a wide and flexible remedial provision such as proposed in the preceding paragraph can be effective only if adequate procedures are made available for its enforcement. The lack of availability of such procedures has been one of the principal reasons for the comparative infrequency of litigation under Canadian statutory provisions that specify the responsibilities of those in control of business enterprises. The problems involved are in part procedural; for example, the courts limit the circumstances in which a corporate shareholder may conduct a derivative or representative action on behalf of his company.* Of even greater significance are the problems of costs, outlined in paragraph 9.11. In our determination of the appropriate procedures to avoid these problems, we have taken cognizance of the opinion held by many commentators in Canada that it would be unwise to "let down the flood-gates" by the introduction of legislation that might result in litigation against corporate officers and directors on the scale experienced in the United States. To some extent, we share this concern; litigation commenced on a speculative basis without reasonable grounds for the existence of a cause of action is undesirable. For that reason, we agree with the prohibitions against acceptance by Canadian lawyers of actions on a champertous or contingency basis. On the other hand, we think that facility should be provided for any transaction that might reasonably be regarded as

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* Foss v Harbottle (1843), 2 Hare 461, 67 E.R. 189 (Ch.) discussed in Ziegel (ed.), Studies in Canadian Company Law (1967) 545.

abusive to be challenged, even if that would increase the volume of litigation. In any event, we very much doubt that there would be a major increase.

9.35 We have concluded that legislation which embodies the statutory prohibitions and the standard of conduct in the preceding section should clearly specify that the appropriate administrator or any shareholder or unitholder of a mutual fund, provided that the shareholder or unitholder was such at the time of the transaction complained of, is authorized to commence and continue an action in which he alleges that a transaction or transactions fell within the classes of prohibited transactions, or constituted a violation of the statutory standard, or both. The action would be conducted on behalf of the mutual fund, which would be named as a plaintiff. Defendants in the action would include those found, as described in paragraph 9.31, to have the legal power and right of control over the mutual fund, or in fact to be able to control it, and therefore to be subject to the standard with respect to the particular mutual fund. Defendants could also include, if thought fit, the other party or parties to the transaction complained of, and any other persons or companies necessary to enable the court to provide an appropriate remedy. If the mutual fund is incorporated, or if it is organized as a trust with specified trustees or governors able to act on behalf of the trust, its board of directors or equivalent body should have the right to initiate the proceedings; they should also have the right where the action is commenced by an administrator or by a shareholder or unitholder to apply for a court order granting the mutual fund conduct of the proceedings. Such an order should be granted only if the court is satisfied that the mutual fund would prosecute the litigation at least as effectively as would the original plaintiff.

9.36 When the action is being carried on by the mutual fund itself, either under a court order made pursuant to the conclusions in the preceding paragraph, or because it initiated the action, any shareholder or unitholder who was such at the time of the transaction or transactions complained of should have the right to carriage of the action on showing that it is not being prosecuted diligently by the mutual fund. Statutory provisions to this

effect would in our opinion, be sufficiently flexible for successful application in all of the various situations that may arise. These arrangements would facilitate challenges to the questionable transactions. Further provisions would be necessary to resolve the problem of costs.

9.37 With respect to costs, it is helpful again to consider precedents from other legislation. The federal self-dealing prohibition does not deal with this question. The proposed Business Corporations Act (Ontario), Bill 125, contains a provision that would permit the court to order the corporation on behalf of which a derivative action is carried on to pay the shareholder-plaintiff interim costs, to assist in the conduct of the proceedings. Such an order could be made upon a finding, so far as here relevant, that the shareholder-plaintiff had made reasonable efforts to cause the corporation to commence or continue the action, that he is acting in good faith and that "it is prima facie in the interests of the corporation or its shareholders that the action be commenced". The shareholder-plaintiff would, however, be accountable for such interim costs in the event the action should ultimately be dismissed with costs. The latter requirement, in our opinion, would result in a significant reduction of the practical value of the legislation; our recommendation as to costs is similar in principle to the draft Business Corporations Act provision, but avoids that requirement.

9.38 The second noteworthy precedent is contained in The Securities Act, 1966 (Ontario) and in the corresponding legislation of several other provinces. It relates to insider trading, and provides that a court may order the administrator to carry on proceedings on behalf of a company against a person or company alleged to be liable to the company for transactions effected in contravention of the insider trading rules. Such an order may be made upon application by a shareholder of the company, upon a showing of reasonable grounds for belief that the company has a cause of action and that it has failed to commence or to continue the appropriate proceedings. To the time of writing, no order had been made under these provisions.

9.39 In our opinion, neither of the procedures concerning costs that are outlined in the preceding paragraphs would be appropriate for adoption with respect to mutual funds. We do not believe that government should be required to conduct at its own cost litigation of an essentially private nature on behalf of a company, the benefits of which will accrue to that company; we therefore disagree with the technique in the provisions of the securities acts applicable to insider trading cases. We concur with the principle upon which the provisions of the proposed Business Corporations Act (Ontario) are based, since it seems to us appropriate that an organization should pay the costs of an action conducted for its benefit. As indicated above, we do not agree with the requirement of the latter provisions that interim costs be accounted for.

9.40 We have concluded that the court should be given discretion, at any stage of an action, to order that all costs accrued thereafter by the plaintiff, including costs assessed against him, be paid by the mutual fund. The order could, in the further discretion of the court, encompass previously accrued costs, and could be made subject to compliance with such conditions as the court thought fit; all costs paid pursuant to the order would, of course, have to be assessed by the appropriate judicial officer. Costs awarded to the plaintiff who has the benefit of such an order should be charged to the mutual fund involved. Such an order would be made if the court was satisfied that the mutual fund, (or its trustee, if it was organized as a trust), had failed to commence the action or that it had commenced the action but failed to prosecute the proceedings diligently, and if the court was also satisfied that continuance of the action was _prima facie_ in the best interests of the mutual fund or its shareholders or unitholders. In its consideration of the latter point the court could take into account the relationship between the potential benefit to be derived from the litigation and the costs involved in its prosecution. The court would have power to rescind or amend this order at a later date if it was being abused, although in the absence of fraud it could not deny the right to costs accrued prior to the rescission or amendment.

9.41 For the reasons set out in this section, we recommend:

(1) that in cases where the court finds that a transaction constitutes a violation of the prohibitions or of the statutory standard of responsibility enacted pursuant to paragraph 9.32, it should have wide authority to determine a remedy appropriate to the particular case, including but not limited to rescission of the transaction; damages; and injunctive remedies;

(2) that any shareholder or unitholder of a mutual fund who was such at the time of the transaction or transactions complained of, or the appropriate administrator, should be authorized to commence and to continue in the name of the mutual fund an action in which he alleges that a transaction or transactions by the mutual fund violated legislation enacted pursuant to recommendations in paragraph 9.32;

(3) that the defendants to an action pursuant to recommendation (2) could include any or all of the persons to whom the statutory standard of conduct is applicable pursuant to paragraph 9.32, recommendation (8); the other party or parties to the transaction or transactions complained of; and any other persons or companies necessary to enable the court to provide an adequate remedy;

(4) that the action contemplated by recommendation (2) could also be initiated by any board of directors or other body which properly represents the mutual fund; in the event that the action is commenced by a shareholder or unitholder or by the appropriate administrator such board of directors or other body could apply for a court order giving it conduct of the proceedings;

(5) that where the action is being carried on by the board of directors or other body pursuant to recommendation (4), any shareholder or unitholder who was such at the time of the transaction complained of, or the appropriate administrator, could apply to the court at any time to be given carriage of the action on the ground that it was not being prosecuted diligently by the mutual fund;

(6) that where the action is carried on by the board of directors or other body pursuant to recommendation (4), legal and other costs should be paid by the mutual fund; where it is carried on by a shareholder or unitholder or by the appropriate administrator pursuant to recommendation (2) or to recommendation (5), the court should have power at any stage of the action to order that all costs accrued by the plaintiff including all costs assessed against him, be paid by the mutual fund; such an order could, at the discretion of the court, relate back to the commencement of the proceedings and would be made upon the basis of the following findings:

   (a) that the board of directors or equivalent body of the mutual fund had failed to commence the action or had commenced it but had failed to prosecute it diligently; and

   (b) that continuance of the action was *prima facie* in the best interests of the mutual fund and its shareholders or unitholders. In the determination of this point the court could take into account the relationship between the potential benefit to be derived from the litigation and the costs involved in its prosecution;

any order made pursuant to this recommendation could be made subject to compliance with such conditions as the court thought fit; costs awarded should be assessed by the appropriate judicial officer; and

(7) the court should have power at any time to rescind or amend an order made pursuant to recommendation (6), but in the absence of fraud, such rescission or amendment should not affect costs accrued to the date of the rescission or amendment.

Disclosure of Potentially Abusive Transactions

9.42 The application of a statutory standard of responsibility, and the availability of a judicial procedure to enforce that standard, will be of little value unless transactions susceptible of challenge are disclosed to persons who will be prepared to carry on the litigation necessary to challenge them. We comment in paragraph 9.12 on the difficulties involved in the appli-

cation of a disclosure requirement designed to reveal abusive transactions, but we have concluded that a serious attempt should be made to require such disclosure. In our opinion, the most feasible technique for this purpose is that which has been adopted in several provinces to enforce disclosure of information relating to insider trading. A report should be made to the appropriate administrator concerning each transaction that falls within certain defined categories, and the administrator should have authority to publish any or all of the reports received. We would anticipate that the power of publication would be used, so that shareholders or unitholders could be alerted to any doubtful transactions. We have considered whether a copy of reports made with respect to a mutual fund should be required to be disseminated to its shareholders or unitholders on a regular basis, but have concluded that such a requirement would be unduly onerous. Whether or not the reports are published, they should be available for public inspection.

9.43 In the implementation of the disclosure requirements we propose, it should be made clear that transactions are not to be regarded as prohibited transactions or as violations of the statutory standards of responsibility merely because they must be reported. Equally, a transaction may be subject to challenge even though it is not required to be reported. The list of transactions to be reported should be designed to encompass those which present the greatest potentiality for abuse but should be sufficiently restricted that only a comparatively small per cent of transactions of any mutual fund would have to be reported.

9.44 In determining the categories of transactions that should be required to be reported to the appropriate administrators, we have made use of much simplified version of the categories of self-dealing transactions defined in the 1940 Act. For reasons substantially similar to those set out in paragraph 9.22, we have rejected the 1940 Act definition of affiliated person in favour of the narrower approach adopted in the federal self-dealing prohibition, as modified by our conslusions in paragraphs 9.24 to 9.27. In the following paragraphs, the associates of a mutual fund are persons or companies

investments in which or loans to which are prohibited for that mutual fund under our conclusions.

9.45 We have concluded that a report to the appropriate administrator should be required with respect to any transaction made by a mutual fund and falling within any of the following categories, such report to be made by the management company within thirty days following the end of the month in which the transaction occurs:

(a) A purchase from or a sale to an associate; this would include a loan whether made by the associate to the mutual fund or by the mutual fund to the associate. In many cases one or more brokerage firms will be associates of the mutual fund, and this category will include all purchases of securities from, and sales of securities to, such brokerage firms. There might be many such transactions, and we make a suggestion below designed to relieve the burden which would be involved if a report was required for each of them;

(b) A purchase or sale effected through an associate acting as agent, with respect to which the associate received a fee either from the mutual fund or from the other party to the transaction, or from both of them. The comment made in category (a) with respect to cases where brokerage firms are associates is also applicable here; and

(c) Any transaction in which, by arrangement, the mutual fund is a joint participant with an associate; it should be noted that we do not anticipate that this category will include instances where an insider of the management company effects transactions in the market on the basis of his information concerning programmes of accumulation or liquidation proposed by the mutual fund, a topic upon which separate recommendations are made later in this chapter.

9.46 As indicated in the comments made above, categories (a) and (b) will in some instances apply to a considerable number of transactions; the same may, in certain situations, be true of category (c). We have concluded

that the administrators to whom the reports are required to be made should be entrusted with authority to exempt classes of transaction from the reporting requirement, subject to any conditions that might seem appropriate. This power should be used to grant an exemption from categories (a) and (b) with respect to transactions in listed securities effected on recognized stock exchanges at currently quoted exchange prices. The order should specify what stock exchanges were recognized, but the list should be extensive. An exemption should also be provided for transactions in debt instruments issued by governments or by corporations with established dividend records, if purchased at not more than their principal amount or sold at not less than their principal amount (in either case with appropriate adjustment for interest) and if brokerage fees or commissions paid are at not more than the prevailing rate. It may be that other general exemptions would be equally appropriate, and those responsible for the preparation of the regulations should be receptive to reasonable suggestions from the mutual fund industry in this connection. These exemptions could be made subject to a condition that certain information be supplied separately to the appropriate administrator, in order that he would be able to determine whether the course of transactions constituted a violation of the statutory standards for responsible investment management. Other general exemptions might seem appropriate after some experience with the legislation; of course, the availability of an exemption would effect only the obligation to report, not any potential liability arising from the transaction.

9.47 For the reasons set out in this section, we recommend:

(1) that the management company of a mutual fund be required, subject to recommendation (2), to report to the appropriate administrator any transaction falling within any of the following categories within thirty days after the end of the month in which the transaction occurs; in the following categories, the word "associate" is defined as in paragraph 9.32, recommendation (2):

(a) a purchase by the mutual fund from, or a sale by it to, an associate, including a loan by either to the other;

(b) a purchase or sale effected by the mutual fund through an associate, with respect to which the associate receives a fee either from the mutual fund or from the other party to the transaction or from both of them; and

(c) any transaction in which, by arrangement, the mutual fund is a joint participant with an associate; insider trading in portfolio securities, as defined in paragraph 9.57, recommendation (4) should be excluded from this category;

(2) that the appropriate administrator should have power by order to exempt any class of transactions from the reporting requirement recommended in recommendation (1), subject to compliance with such conditions as he thinks fit; this power should be exercised immediately to exclude from clauses (a) and (b) of recommendation (1):

(a) transactions in listed securities effected on recognized stock exchanges at currently quoted exchange prices; the order should include an extensive list of recognized stock exchanges; and

(b) transactions in debt instruments issued by governments or by corporations with established dividend records, if purchased at not more than their principal amount or sold at not less than their principal amount (in either case with appropriate adjustments for interest) and if brokerage fees or commissions paid are at not more than the prevailing rate;

Those responsible for the preparation of the regulations should be receptive to reasonable suggestions for additional exemptions from the mutual fund industry;

(3) that the fact that a transaction must be or need not be reported pursuant to recommendations (1) and (2) should be irrelevant to whether it constitutes a violation of legislation implementing recommendations in paragraph 9.32; and

(4) that the appropriate administrator should have and should exercise the power to publish reports received pursuant to recommendations (1) to (3).

Insider Trading

9.48 Insider trading is only one manifestation of the general problem of conflicts of interest, but is difficult to treat together with other aspects of the problem. The basic objection to most of the types of transaction considered in the preceding sections of this chapter is that money belonging to the mutual fund may be used for the benefit of persons other than the shareholders or unitholders of the mutual fund. In insider trading, no direct use is made of the mutual fund's money; the "insider" is at risk, and in many instances it would be difficult to establish any direct damage to the mutual fund. Because of this, and because of the nature of the transactions involved, we have concluded that this problem should be dealt with somewhat differently from other aspects of conflicts of interest.

9.49 In section 113 of The Securities Act, 1966 (Ontario) abusive insider trading is defined as the use by an insider in connection with a transaction relating to the securities of the company of which he is an insider, of any specific confidential information for his own benefit or advantage that, if generally known, might reasonably be expected to affect materially the value of the securities. Similar provisions are embodied in the legislation of British Columbia, Alberta, Saskatchewan and Manitoba. We accept it as an appropriate definition in the context of mutual funds, subject to one important exception. This is that in the context of mutual funds there are two types of insider trading, only one of which involves transactions in securities issued by the mutual fund. The second, and in our opinion the more serious, involves transactions in securities held, previously held or to be held by the mutual fund. We refer to the latter as insider trading in portfolio securities.

9.50 Insider trading in securities issued by the company of which the trader is an insider has attracted considerable attention in recent years. As indicated above, it has been the subject of legislation in five provinces. The statutory provisions, except in British Columbia, apply only to incorporated mutual funds. As a result, persons who satisfy the definition

of insider with reference to mutual funds organized as companies, but not with reference to mutual funds organized as trusts, must report their trading in shares of the mutual fund and are subject to liability for profits made in such trading through the use of confidential information. For an insider to be held liable, he must be found to have violated the statutory test summarized in the preceding paragraph.

9.51 With insider trading in portfolio securities, the confidential information is that the mutual fund is about to trade and thereby may affect the market price of the particular security. Such trading can be very profitable for persons who possess this type of information, since a major investment or liquidation programme conducted by a mutual fund can have an immediate effect on the market price of the security concerned. It is a type of trading that, in our opinion, should be discouraged principally because it is so obviously unfair and may distract the investment manager or other insider from his primary responsibilities, and also because it may prejudice the mutual fund by absorbing all or part of the available supply of or demand for a security thereby making the programme of purchase or sale more difficult and (perhaps) more expensive to complete.

9.52 We have concluded that, with the adoption of forward pricing, as suggested in paragraphs 13.65 to 13.68, there would be virtually no possibility that an improper profit could be made through trading by mutual fund insiders in shares or units of the mutual fund. Mutual fund share prices are based on the net asset value per share, computed regularly; the insider cannot predict in advance what they will be except by predicting a change in value of one or more portfolio securities, in which event his profit is far better made by trading in the portfolio security. We can appreciate that there is some reason for participants in a mutual fund to be interested in the extent of the investment made by insiders in the mutual fund, but we have concluded that this interest does not justify the imposition of a requirement that all transactions be reported. For that reason, we have concluded that the legal requirements relating to trading by insiders in securities of

companies of which they are insiders should be made inapplicable to mutual funds, but that mutual fund prospectuses should be required to include information concerning the investments made in the mutual fund by its insiders, including the total holdings of each insider at the date of the prospectus.

9.53 In the implementation of the conclusion expressed in the preceding paragraph, we feel that certain changes are necessary in the definition of insider. The present arbitrary distinction between incorporated and trusteed mutual funds should be eliminated, and the definition so prepared as to encompass the trustees, governors, or other appropriate persons related to a trusteed mutual fund. In addition, the disclosure requirement should extend to insiders of the management company and the distribution company. They are usually as closely associated with the mutual fund as are its own insiders.

9.54 With respect to insider trading in portfolio securities, we have concluded that a statutory responsibility should be imposed on all persons who are insiders within the definition proposed in the preceding paragraph, and on every other person found to have access by reason of his position to information concerning the investment programme of a mutual fund. All such persons would be prohibited from making use of that information in the manner described in paragraph 9.49 except that the definition summarized in that paragraph should be modified to encompass trading in portfolio securities. The legislation should provide remedies similar to those available under securities legislation with respect to trading in securities of companies in which the trader is an insider; any profits made should be recoverable by the mutual fund, and a procedure similar to that outlined in paragraphs 9.33 to 9.41 should be available so that proceedings could be initiated or continued by a shareholder or unitholder or by the appropriate administrator. We do not feel that a cause of action should be made available to those from whom the insider purchases or to whom he sells, for buying and selling are what the securities market is all about and the intention to buy or sell should not be regarded as an item of information the concealment

of which should result in a claim for damages against the person who trades without revealing that intention. We have, however, concluded that this type of transaction should be made an offence punishable as such under the generally applicable penalties section of the relevant legislation.

9.55 The conclusion in the preceding paragraphs deals with only one of the three questions to be resolved by remedial legislation. It sets a standard of liability, but neither indicates how transactions which may violate that standard are to be disclosed nor deals with the financial problems encountered by plaintiffs in litigation to enforce the standard. These questions have caused us considerable concern. We have considered the obvious expedient to enforce disclosure, a reporting requirement similar to that proposed in paragraph 9.42, and have decided that this approach would not be feasible. It would have to encompass all trading in any securities by all insiders of the mutual fund, since there is no necessary relationship between an abusive transaction and portfolio content at a particular time. Even if the reporting requirement were limited to transactions in securities held at the time or acquired within a prescribed period by the mutual fund, we think it would be cumbersome and might well prove unworkable.

9.56 We have concluded that enforcement of the restriction on insider trading in portfolio securities should be the responsibility of the management company. Each management company should be required to identify those persons who are insiders under the definition proposed in paragraph 9.53, or who by reason of their positions have access to information concerning investment decisions, and to impose on them an internal reporting requirement adequate to encompass all transactions that might violate the statutory standards. The reports should be kept on file, available for inspection by the appropriate administrator and by the mutual fund auditor. In addition, the management company should have a regular procedure whereby the reports are compared with its own trading record to detect abusive transactions, and proceedings are taken to recover the appropriate damages. These proceedings should ordinarily be at the expense of the management company;

the special provisions concerning payment of costs by the mutual fund should not be applicable here. If the appropriate administrator is not satisfied with the adequacy of the procedures, or not satisfied that they are being properly carried out, he could require a statement to that effect to be included in the annual report and prospectus of the mutual fund.

9.57 For the reasons set out in this section, we recommend:

(1) that the requirements of securities acts in the several provinces relative to reporting of, and liability for, insider trading should be made inapplicable to mutual funds;

(2) that, for purposes of the following recommendations, the term "insider" should include with respect to a mutual fund, its board of governors, trustees, or equivalent body and the persons who are insiders of its management company or its distribution company under the securities acts of the several provinces;

(3) that mutual fund prospectuses should include information concerning investments made in the mutual fund by its insiders, including the total holdings of each insider at the date of the prospectus;

(4) that insiders of a mutual fund and each other person who by reason of his position has access to information concerning its investment programme should be subject to a statutory prohibition against effecting transactions in securities held, previously held, or proposed to be held by the mutual fund, where such transactions are motivated by knowledge of information concerning the investment programme of the mutual fund; such transactions, are referred to in the following recommendations as "insider trading in portfolio securities", and such transactions, when so motivated, are referred to as "improper insider trading in portfolio securities";

(5) that persons who engage in improper insider trading in portfolio securities should be subject to civil liability in favour of the mutual fund, similar to the liability prescribed by section 113 of The Securities Act (1966), (Ontario) and corresponding legislation in other provinces and should also be subject to punishment under the generally applicable penalties section of the relevant legislation; such persons should not be subject to a statutory civil liability to those with whom they trade similar to that prescribed by Section 113;

(6) that provisions similar to those recommended in paragraph 9.41 should be made available for the effective enforcement on behalf of the mutual fund of civil liabilities arising under legislation which implements recommendation (5);

(7) that each management company should establish internal procedures to review insider trading in portfolio securities, in order to detect improper insider trading in portfolio securities, which procedures should include a regular reporting requirement by all insiders of the mutual fund and by all other persons who by reason of their position have access to information concerning the investment programme of the mutual fund, and a regular procedure whereby the reports made are compared with the trading record of the mutual fund; and

(8) that the reports made pursuant to legislation which implements recommendation (7), the trading record and other relevant documents should be kept available for inspection by the appropriate administrator, and by the mutual fund auditor. The appropriate administrator could require the inclusion of an appropriate statement in the annual report and prospectus of the mutual fund if not satisfied with the procedures followed.

CHAPTER X

MANAGEMENT FEES AND SALES CHARGES

10.01 In Chapter II we discuss the existing competitive situation within the Canadian mutual fund industry. For analytical purposes, we there distinguish between two segments of the market for mutual fund shares or units: purchasers for whom they are unsought goods, and purchasers for whom they are shopping goods. Our conclusions are, briefly, that a high level of competition exists, as might be expected in an industry with many participants and comparatively low barriers to entry; but that the competitive structure contains certain anomalies as a result of which it does not provide the benefits ordinarily available through competition. Both segments of the market are characterized by competitive attempts to produce superior performance, which is in practice judged largely by rate of return. This competition for quality is beneficial to the investor, although we criticize the degree of emphasis on rate of return. Competition for lower sales charges also exists at the consumer level, but only in the shopping goods segment of the market. A very important conclusion is that purchasers for whom mutual funds are unsought goods do not ordinarily receive the benefit of sales charge competition. This conclusion is also relevant to management fees. Because of its importance, we summarize in the following paragraphs the more important factual findings which support it.

10.02 The shopping goods segment of the market, which is by far the smaller of the two segments, consists of purchasers prepared to investigate the relative merits of various mutual funds in an endeavour to analyze which

mutual fund is best for them. Such investigation might consist of comparisons made by the purchaser, or reliance might be placed upon analyses prepared by the financial press or other media. Whatever the method of investigation, the analysis takes into account at least the three major criteria: quality of investment performance, level of sales charges, and size of management fees.

10.03 The unsought goods segment of the market consists of purchasers with reference to whom the saying was coined that shares or units of mutual funds "aren't bought, they're sold". Such purchasers ordinarily invest on the basis of a sales presentation, and do not make detailed comparisons between mutual funds; in many cases, they are not aware that differences exist between mutual funds, except with respect to quality of investment performance. Many make comparisons on the latter point, although in Chapter III we criticize the emphasis placed upon rate of return as a determinant of the quality of investment performance and we summarize the results of a consultants' report in which doubt is cast on the predictability of future results on the basis of past performance. While salesmen may discuss sales charges and management fees, purchasers in the unsought goods segment of the market are generally unaware that significant differences exist between mutual funds on these matters.

10.04 It is difficult to generalize concerning the segment of the market appealed to by particular mutual funds or distribution companies. It appears clear that most or all mutual funds the shares or units of which are sold subject to sales charges below 8.0% of the amount paid by the purchaser, or without sales charges, appeal primarily to the shopping goods segment of the market. Most of these mutual funds are organized by brokerage firms for their clients, or are trust company investment funds. They do not have extensive distribution networks and must be sought out by a purchaser instead of being brought to his attention by a salesman.

10.05 While mutual funds the shares or units of which are sold subject to sales charges at a basic rate of more than 8.0% make the principal appeal to the unsought goods segment of the market, it would not be correct to assume that their appeal is exclusively to that segment. They endeavour to

attract purchasers for whom mutual funds are shopping goods through stress on investment performance, in recognition of the fact that price must be balanced against quality and that superior performance can more than justify higher sales charges in the eyes of the purchaser who makes comparisons. They also appeal, through a system of lower sales charge rates for large volume transactions, to the shopping goods purchaser who is able to make a large purchase; as indicated in paragraphs 2.18 and 2.19, the size of the discounts involved can be very substantial.

10.06 It is not clear to what extent shares or units of mutual funds with sales charges in excess of 8.0% are sold to purchasers for whom they are shopping goods, but it is clear that these mutual funds make the principal appeal to purchasers for whom mutual funds are unsought goods. Their distribution companies must compensate the salesmen, whether they are associated with direct sales forces, independent sales forces, or brokers, for the time and trouble involved in sales to such purchasers. The anomalous result is that competition does not operate to reduce sales charges to the consumer, but to maintain them at maximum levels in order to permit compensation of salesmen. A distribution company that reduced compensation to salesmen on a direct sales force would lose the salesmen to other organizations; a distribution company that reduced compensation to brokers or independent sales forces would find that the salesmen tended to concentrate on the distribution of other mutual funds.

10.07 The absence in the unsought goods segment of the market of comparisons by purchasers with respect to sales charges makes competition at the consumer level almost completely ineffectual as a constraint on the consequences of the competitive pressure to increase sales charges. As a result, the effective constraint on such increases has been the discretionary policies of securities administrators, and the distribution companies that appeal to the unsought goods segment of the market all levy a basic sales charge at the maximum level which the securities administrators regard as tolerable.

10.08 We also comment in Chapter II on the two different kinds of sales charge competition which could operate in favour of the investor. The first, exemplified by volume discounts and by lower sales charges for mutual funds which appeal primarily to the shopping goods segment of the market, is competition between distribution companies. The second would be competition between sales outlets of a particular mutual fund under which one or more of those sales outlets would offer shares or units of the mutual fund at a lower sales charge rate than is prescribed by the prospectus and levied by other sales outlets. The latter type of competition is discouraged by distribution companies through use of the techniques described in paragraphs 2.52 to 2.57, which dissuade sales outlets from agreeing with purchasers to accept less compensation in order to reduce the cost to the purchaser.

10.09 We have concluded that the anomalies of the current competitive structure in the Canadian mutual fund industry must be eliminated if competition is to operate effectively on behalf of the investor. In this chapter we make recommendations with that objective. Such recommendations will, it is hoped, result in effective competition at the consumer level not only with respect to sales charges but with respect to management fees, considered in the next section. We also make recommendations to provide substantive controls over sales charges and management fees until competition becomes fully effective. The concluding section of the chapter deals with the specific question of sales charges on contractual plans.

Existing Regulatory Requirements; The Competitive Situation with Respect to Management Fees

10.10 Management fees and sales charges are usually treated as separate questions by the Canadian mutual fund industry and by securities administrators. Levels of each have been considerably affected by practices in the United States, which operate both directly as a precedent for Canadian mutual funds and indirectly as a model to be followed by Canadian securities administrators. It is therefore relevant briefly to review developments in that country. In both countries management fees are almost invariably computed and expressed as a percentage of the total net assets of the mutual fund concerned.

In both countries, sales charges are almost invariably computed and expressed as a percentage of the amount paid by the purchaser rather than of the amount invested in the mutual fund. Expressed on the latter basis, the prevailing sales charge rate of 8.5% would be almost exactly 9.3%.

10.11 In the United States, there is no direct legislative control applied to management fees. The courts have, however, been prepared to entertain actions brought by shareholders of mutual funds based on allegations that management fees "were unreasonable and excessive and that payment thereof constituted a waste of the funds' assets and a breach of fiduciary duty".* In several instances, particularly with the larger mutual funds, such an action or the threat of such an action has resulted in a decrease of management fees. This is usually effected through the adoption of a scale of percentages to be used in the determination of management fees which applies lower percentages to dollar amounts of total net assets above specified levels in order to recognize economies of scale. In spite of this development, the Securities and Exchange Commission concluded in 1966 that the prevailing rate for management fees was and continued to be one-half of one per cent of average total net assets per year, and that the benefit of economies of scale realized by the management companies of the larger mutual funds under this prevailing rate was not being adequately passed on to the mutual funds.

10.12 The Investment Company Act of 1940 contains specific provision as to maximum size of sales charges on contractual plans. Section 27 contains provisions upon which a number of the proposals in paragraphs 8.52 to 8.63 are based; it also states that the sales charge levied over the life of the plan may not exceed 9% of total payments, being about 9.9% of the total amount invested. While the 1940 Act contains no similar specific limitation on the sales charges that may be levied on purchases other than those made under contractual plans, the industry in the United States has accepted 9% as the maximum

* Public Policy Report (supra, para. 1.07) page 133. Chapter III of that report contains a full discussion of the management function and its cost in the United States, including recommendations of the Securities and Exchange Commission.

rate even for such purchases. In practice, the prevailing charge is 8-1/2% of the amount paid by the purchaser, being 9.3% of the amount actually invested. There are exceptions to this in the United States, as there are in Canada, and volume discount arrangements such as those described in paragraphs 2.18 to 2.20 are also available in the United States.

10.13 In paragraph 1.66 we set out and indicate our agreement with a passage from the brief of the Canadian Mutual Funds Association in which the prevailing level of sales charges in Canada is attributed to adoption of the pattern in the United States. The same is true of management fees. In both aspects of industry operations the first mutual funds organized in Canada followed practices that were developed in the United States, and the pattern they established has endured ever since in this country. With respect both to sales charges and to management fees, this is in large part attributable to the policies of securities administrators who have been reluctant to accept prospectuses for filing if they contemplated payment of rates higher than the prevailing rates. For those of us who are securities administrators these decisions have been difficult ones, and we have long been aware of the need for more precise guidelines and procedures in these areas.

10.14 The policies of securities administrators on levels of sales charges and management fees are for the most part unwritten, although well known to the mutual fund industry. They vary in detail between provinces, and exceptions to them are made in cases which seem appropriate. The following quotation from a memorandum of the Superintendent of Brokers of British Columbia distributed in February 1967 is representative of the policy usually applied to the front-end load on contractual plans.

> POLICY RESPECTING SALE OF SHARES OR UNITS OF OPEN-END INVESTMENT (MUTUAL) FUNDS UNDER CONTRACTUAL PLANS
>
> 1. The total load should not exceed 12% of the value of the contract. This total load shall include all charges including sales charges, custodian fees, creation fees, etc., but does not include the fund management fee.

2. The deductions to cover the total load should not exceed

    (a) 50% of the first 12 monthly installments provided for under the plan or

    (b) 40% of the first 15 monthly installments provided for under the plan.

These deductions are to be made in equal percentages monthly, the balance of the load deductions are to be pro-rated over the balance of the life of the contract. Where a double installment is required in the first month of a plan it shall be regarded as one of the first 12 or 15 installments as the case may be.

Similar memoranda were distributed by several other securities administrators. In addition, the administrators restrict the sales charges on lump sum purchases to approximately 8.5% of the amount paid by the purchaser.

10.15 Prevailing levels of management fees cannot be as readily described, because management fees can be considered either alone or together with other management expenses. Table X-A clearly indicates the disparity in practices followed in the allocation of management expenses between mutual funds and management companies. That table shows the percentage of mutual funds that are required to pay each of a number of types of expense over and above their management fees. It is apparent that the management fee can in effect be increased by the allocation to the mutual fund of management expenses, and therefore it is unfair to compare management fees without allowance for management expenses. In spite of this, policies of most administrators have emphasized the management fee rather than allocation of management expenses. Table X-B shows that while, principally as a result of the policies of securities administrators, management fees have tended to cluster at the rate of .5 of 1% of average total net assets per year, there is far greater disparity in management expenses.

TABLE X-A

MANAGEMENT SERVICES PAID FOR BY CANADIAN MUTUAL FUNDS IN ADDITION TO THE MANAGEMENT FEE

Management Service	Percentage of Mutual Funds Which Pay For Management Service
Technical and other investment advisory or consultant services	0%
Clerical and bookkeeping	10%
Occupancy and office rental	10%
Accounting services	12%
Determination of offering and redemption price	14%
Compensation of individuals associated with the fund (officers, directors, employees)	31%
Stationery supplies and printing	50%
Custody of portfolio securities	58%
Registration and filing fees	60%
Legal fees	62%
Transfer charges	68%
Reports to shareholders	70%
Auditing charges	83%

Notes: (1) This table reflects information at December 31, 1967 concerning Canadian-organized mutual funds qualified for sale in Canada at that date, including trust company investment funds. Approximately 15 mutual funds are not included because of lack of availability of information.

(2) To restrict the number of expense categories, it has in some cases been necessary to allocate an expense item for a particular mutual fund to a certain category although it did not fit precisely within that category.

TABLE X-B

MANAGEMENT FEES AND MANAGEMENT EXPENSES
PAID BY CANADIAN MUTUAL FUNDS IN 1967

Range of Fees or Expenses as a % of Average Total Net Assets	Number of Mutual Funds	Percentage of Aggregate Total Net Assets of all Mutual Funds
a) Management Fees		
less than .3	22	4.1%
.3 to .5	31	23.2
.5 to .6	26	68.5
.6 to .7	3	.5
.7 to 1.0	6	1.2
1.0 to 1.5	5	1.2
1.5 to 2.0	3	.6
over 2.0	1	.7
Total	97	100%
b) Management Expenses (Including Management Fees)		
less than .3	12	1.7%
.3 to .5	9	10.2
.5 to .6	17	54.1
.6 to .7	13	22.0
.7 to 1.0	18	8.0
1.0 to 1.5	12	2.0
1.5 to 2.0	6	.8
over 2.0	10	1.2
Total	97	100%

Notes: The table relates only to Canadian-organized mutual funds qualified for sale in Canada at December 31, 1967. Nine such funds for which the information was unavailable are omitted. Two of these are The Diversified Income Shares Series A and B, commented on in the preface. Aggregate total net assets of the other seven were insignificant by comparison with the industry as a whole.

10.16 To resolve the problems of the relationship between management fees and management expenses, the Quebec Securities Commission has for some years required that the total of management fees and other management expenses paid by a mutual fund not exceed 1% of its average total net assets on an annual basis. In February 1968 the Ontario Securities Commission adopted a more complicated policy, designed to recognize the relationship between management fees and management expenses, and also to ensure that economies of scale are reflected in the management fee. This policy is of such importance that we here reproduce it in full:

> Pending the policy which may be developed as a result of the studies now being conducted by the Canadian Mutual Fund Committee, all mutual funds are advised that the maximum management fees and other expenses which may be charged against the assets of the fund, expressed as a percentage of the net assets under administration, are as follows:
>
> | | |
> |---|---|
> | Up to $1,000,000 | 2% |
> | $ 1,000,000 up to $ 3,000,000 | 1-3/4% |
> | $ 3,000,000 up to $ 5,000,000 | 1-1/2% |
> | $ 5,000,000 up to $ 10,000,000 | 1-1/4% |
> | $ 10,000,000 up to $100,000,000 | 1% |
> | $100,000,000 and over | .75% |
>
> This policy will be applied to all new funds whose securities are for the first time the subject of a filing and all funds making an annual refiling or making a new filing.
>
> Within the limits and percentages set out above, sliding scale or incentive management fees will be accepted.
>
> It is again emphasized that the maximum percentage is to include not only the management fee chargeable but also all other expenses.*

10.17 A supplementary interpretative release, published by the Ontario Securities Commission in January 1969,** is not here reproduced. It was issued not to change the substance of the original release but to clarify it. The interpretative release confirms, among other things, that the lower percentage limits on the higher dollar amounts are not meant to determine total compensation. For example, a mutual fund with $1,500,000 total net assets could pay up to 2% for management fees and expenses on the first $1,000,000, and up to 1-3/4% on the remaining $500,000.

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* Ontario Securities Commission, Bulletin, February 1968, page 18.

** _Ibid_ January 1969, page 6.

10.18 The discussion in Chapter II of the competitive situation in the mutual fund industry deals in particular with sales charges. Two facts might be pointed to in support of a contention that the conclusions there reached do not apply to management fees. First, emphasis is given in Chapter II to the disparity in sales charge rates between mutual funds which do and those which do not appeal primarily to the unsought goods segment of the market; there is no corresponding disparity in management fees. Second, Table X-B shows greater disparity in management fee and management expense rates than does Table II-C in sales charge rates. We do not accept either fact as sufficient to support the contention, and have concluded that our analysis of the competitive situation for sales charges is also applicable to management fees.

10.19 That there is no disparity in management fee rates between the shopping goods and unsought goods segments of the market to correspond with the disparity in sales charges is largely attributable to the lesser importance of management fees to the purchaser. Sales charges at over 8.0% of the amount invested seem of more importance to him than a management fee of .5% annually, so that even mutual funds which cater to the shopping goods segment of the market have not been forced by competition to reduce management fees. The variance in management fees and expenses for the industry as a whole can be accounted for by the differences among the rules applied by various administrators. The greater variance in management expense rates is explained by the concentration of administrative requirements in many provinces on management fees rather than management expenses. There are only two relevant differences between the competitive position for management fees and that for sales charges, neither of which affects our basic conclusions. The first is that the pressure for higher management fees arises from the desire for profit rather than the necessity to compensate salesmen, and this is really a distinction without a difference. The second is that with respect to management fees there is no necessity for price maintenance agreements of the type described in paragraphs 2.52 to 2.57. The sales outlet is not in a position to rebate any portion of the management fee to the purchaser.

10.20 One further argument might be advanced to affirm that effective competition in management fee rates exists at the consumer level. This argument is based on the fact that the maximum management fees permitted under the Ontario policy ruling are higher, in some cases substantially higher, than those paid by many mutual funds. We have calculated that, had all Canadian mutual funds qualified for sale in Canada with assets in excess of $5 million at December 31, 1967 paid management fees at the maximum rates contemplated by the policy ruling, their aggregate management expense for 1967 would have increased from $13,135,000 to $20,633,000. At the time of writing, 8 mutual funds have adopted fee structures based on the maximum fees permitted under the Ontario policy ruling; all of these mutual funds were made available to the public for the first time after that ruling became effective. It could be argued that, on our conclusion concerning the competitive situation, management fees would be expected to equal the maximum permitted rates, and to rise with those rates. The fact that this has not happened since the publication of the Ontario policy ruling would therefore be said to be sufficient indication that competition is in fact operative to restrain management fees.

10.21 In our opinion, the fact that the prevailing level of management fees in the Canadian mutual fund industry has not increased following the policy ruling made by the Ontario Securities Commission is not attributable to competition as a restraining factor, but rather to a reluctance on the part of existing organizations to increase their management fees. This is confirmed by the number of newly organized mutual funds which have adopted the new fee structure. The reluctance to increase existing fees is, we think, a consequence of two considerations. Such an increase might attract unfavourable attention from securities administrators. More importantly, the necessity to notify shareholders and unitholders of the increase would draw management fees to their attention as an important aspect of operations. For these reasons, we have concluded that the contention described in the preceding paragraph must be rejected, and the conclusion that the competetive situation for management fees is similar to that for sales charges must be affirmed.

Controls Over Rates of Sales Charges and Management Fees

10.22 We have received a number of submissions as to whether prevailing levels of sales charges and management fees are "too high" or "too low". We have reached no conclusion on this question. Any such conclusion would have to be premised on assumptions that were sufficiently definite and precise to permit such an important judgment. The submissions made to us were all premised on various assumptions, none of which we found sufficiently convincing for us to adopt.

10.23 Even if we were to make assumptions upon which conclusions could be based, the practical problems inherent in a judgment on sales charges or management fees might well be insuperable. One way to approach such a decision would be through an analysis of profit levels of management and distribution companies. Such information is often difficult to obtain, because of the problems in a separation of revenue and expenses attributable to mutual funds from those attributable to other activities of the management and distribution companies. In addition, it would frequently be necessary to determine what expenses were appropriate and what ones were not.

10.24 Another way to approach the decision would be to decide what levels of sales charges and management fees were necessary to enable the distribution and management companies properly to perform their functions. Such an analysis would involve a determination of what those functions are and of how costly they are to perform. In the context of sales charges, that determination would be very difficult. Sales charges are primarily used to compensate for the sales activity, and it may safely be assumed that the costs involved in the sales activity increase with the rewards to be earned. If sales charges are high, a salesman may be able to spend a great deal of time with one customer; if they are low, he may not even be prepared to take time to meet the customer.

In addition, the relationship between sales charges and sales may be unpredictable; if sales charges were compulsorily reduced, total sales might increase because prices were lower or decrease because salesmen with comparatively low sales were unable to survive as salesmen. All these factors would contribute to the difficulty in an assessment of whether present levels of sales charges are too high or too low.

10.25 Practical problems in an assessment of management fee levels are similar to those concerning sales charges, although perhaps not as acute. It is at least reasonable to suppose that a determination can be made of the cost of good portfolio management plus a reasonable profit. The brief of the Canadian Mutual Funds Association includes an analysis of the cost of providing research advice, which concludes that an annual budget of $200,000 would be the minimum necessary to provide an adequate staff and facilities. The brief continues: "Even if the costs of providing the other services supplied by the management company are ignored completely, an organization of this size can only be supported by a fund with $40,000,000 in assets at the widely prevailing fee of 1/2 of 1%."

10.26 We do not fully accept the analysis referred to in the preceding paragraph; as another section of the same brief recognizes, reliance on the analytical services provided by brokers under the arrangements described in the discussion of reciprocal business in paragraphs 3.57 to 3.71 significantly alleviates the management company's burden. We do recognize that, if minimum commissions on large stock exchange transactions are reduced, an increase in management fees might be necessary as a result. On the other hand, we have found cases in which a management company charges a higher rate for the management of a mutual fund portfolio than for the management on a contractual basis of a portfolio of comparable size on behalf of a large institutional investor.

10.27 The factors noted in preceding paragraphs, which have prevented us from reaching conclusions as to the appropriateness of prevailing levels of sales charges and management fees, have also led us to conclude that a substitute should be found for the existing regulatory structure in this aspect of industry operations. Securities administrators have, in our opinion, filled a necessary function in restricting the effects of the upward pressure on sales charges and management fees through the imposition of controls on a discretionary basis, but the responsibility they have thereby assumed is very great. The rates they select, while theoretically maxima, in fact are the prevailing rates for distribution companies except those which appeal particularly to the shopping goods segment of the market. As a result, securities administrators have become arbiters of the entrepreneurial reward to be derived from the operation of mutual funds, a role we think they should continue to hold only so long as no feasible alternative is available.

10.28 In our opinion, the only effective way to control the levels of sales charges and management fees would be through the operation of competition in these areas at the consumer level. That will only occur if and when the preconditions referred to in paragraphs 2.38 and 2.39 are satisfied. The first of these, the existence of ability and willingness among mutual fund investors to compare sales charges and management fees before making purchase decisions, will develop when the shopping goods segment of the mutual fund market is considerably extended. That can be brought about only through the use of techniques to provide purchasers with information as to the implications of the factors that differentiate mutual funds, together with the willingness and ability to make use of that information.

10.29 A second precondition must be satisfied if the effect of the consumer pressure which would result from successful implementation of the measures referred to in the preceding paragraph is not to be artificially avoided. Sales outlets should be guaranteed freedom to reduce their portion of sales charges in order to reduce the price to the consumer. At present, distribution companies prevent this through use of the devices described in paragraphs 2.52 to

2.57. The second precondition can be attained only through such measures as are necessary to prevent the use of these devices.

10.30 Institution of the appropriate measures to bring about the two preconditions to effective competition would not alone be sufficient to justify the abolition of the role played by securities administrators in the determination of sales charges and management fees. The measures would almost certainly not be immediately successful; indeed, a long delay might ensue before adequate competition developed. If there were no substantive controls during that period, the upward pressures on sales charges and management fees might result in substantial increases unrestricted by effective competition at the consumer level. An interim control arrangement is necessary, but it must be one with sufficient flexibility to allow room for the operation of competition. Such flexibility is not available under the present regulatory system, so that an alternative must be devised.

10.31 In the next three sections we consider in greater detail the measures necessary to accomplish the objectives described in the preceding three paragraphs. It should be emphasized that we make no suggestion or prediction as to the effect of the institution of these requirements on prevailing rates of sales charges and management fees. They may presently be "too high" or "too low": only the development of effective competition will establish which, if either, is the case.

10.32 For the reasons set out in this section, we recommend:

(1) that appropriate measures, discussed in detail in the following sections, should be instituted:

(a) to disseminate and require the dissemination of information concerning the relative merits of mutual funds in order to encourage the development of a higher degree of competition at the consumer level, particularly in the determination of levels of sales charges and management fees; and

(b) to prohibit the use by distribution companies of devices and arrangements designed to prevent sales outlets from reducing their portion of sales charges in order correspondingly to reduce the price charged the purchaser; and

(2) that appropriate measures, discussed in detail below, should be instituted to avoid undue increases in the level of sales charges and management fees pending the development of effective competition as a result of the recommendations in (1).

Recommendations Designed to Improve the Quality of Consumer Choice; Methods of Disclosure of Sales Charges and Management Fees

10.33 The distinction advanced in Chapter II and in the introductory portion of this chapter between the unsought goods and the shopping goods segments of the market for mutual fund shares or units can for present purposes be equated with a distinction between uninformed and informed purchasers. A purchaser with knowledge of the relevant differences between mutual funds and the ability to apply that knowledge in making comparisons, or at least to make use of a financial survey which includes comparisons, will almost certainly treat mutual funds as shopping goods. The purchaser who lacks this knowledge and ability will probably treat mutual funds as unsought goods. To attain the type of competition that we think desirable, a larger proportion of the public, and in particular of potential purchasers, must acquire such knowledge and ability.

10.34 There is an obvious cost factor in increasing the proportion of purchasers who have the knowledge and ability to compare mutual funds. The argument most strongly advanced by the mutual funds industry in support of the currently prevailing levels of sales charges is based on the cost of information transmission. The argument is stated as follows in the brief of the Canadian Mutual Funds Association:

> Compensation for the information transmission function . . . is provided through the sales charge. There are also funds having zero

sales charge which are available to the investor who has already acquired a familiarity with equity investment, enough detailed knowledge of the alternative funds available to be aware of their existence, and who feels their investment policies meet his requirements. They are listed in the investment manuals and are advertised to some extent in the mass media, but do not attempt the intensive communications effort carried on by the funds which levy a sales charge; nor have the sponsoring organizations in Canada attempted thus far to offer a range of plans with objectives related to investors' requirements.

10.35 We agree that it is appropriate to assume that sales charges are used, at least in part, to compensate for the costs involved in transmission of information. The difficulty is that the nature of the information transmitted by salesmen is not ordinarily such as to encourage or to facilitate the type of comparison we think desirable. This means that the information for which the sales charge is paid is not sufficient to provide the purchaser with the knowledge and ability discussed in paragraph 10.28.

10.36 A second factor relevant to the mutual fund industry's position on sales charges is alluded to in paragraph 10.24. This is that the cost and effort which the salesman is prepared to expend will increase with the reward to be derived from a sale. High sales charges may justify the time and effort necessary to persuade an obstinate person who lacks financial knowledge that an investment in mutual funds is appropriate for him, while a reduction in sales charges would make such time and effort uneconomic. There must be limits on the extent to which high sales charges should be accepted in order to support this type of sales effort. Such limits can, in our view, best be determined through the operation of competition, but that will not occur unless competition in this area becomes effective.

10.37 We have concluded that three principal methods should be used to provide potential purchasers with the necessary knowledge and ability, and that all of these methods must be used in conjunction if effective competition is to be attained. The first involves requirements to govern the content of material supplied by the salesman to the purchaser at the time of sale; in this case, the informational costs are paid by sales charges. The second involves dissemination of information by government, with the costs paid by government. The third involves the press and other communications media, which publish in-

formation available to investors generally; here, the informational costs are borne as part of the costs of the media concerned. In addition, the financial press should be encouraged to publish comparative analyses of mutual funds. A well co-ordinated use of these three methods should, within a reasonable period of time, effectively educate an adequate proportion of the public so that the desirable level of competition will be attained, and also provide analyses upon which comparative study by purchasers may be based.

10.38 The first of the three methods referred to in the preceding paragraph, relying on the material delivered at the time of purchase, is discussed in Chapter XIV. The second, dissemination of information by government, involves an extension of governmental activities to an aspect of affairs in which we think that government has an important role to perform in the public interest. As the Canadian economy becomes more complex, the financial instruments available become more difficult to understand and a comparison of their relative merits is correspondingly harder. Investors with knowledge of the available alternatives are likely to make a far better selection than are those who succumb to the first salesman, or who make no investment at all; the results would enure not only to their benefit, but to that of the entire economy through more efficient allocation of resources. In our opinion, both the provincial and the federal governments should recognize and accept a responsibility to participate in the educational process to the extent necessary in order to enable Canadians to select investments which will provide them with maximum benefit from their savings dollars.

10.39 The third method described in paragraph 10.37 may be the most important. The press and other communications media, including radio and television, pervade our society and provide the most effective vehicle for mass education. These media should contribute to the educational process in two ways: through news articles and background information carried as part of their public responsibility, and through advertisements placed by distribution companies of mutual funds. The latter would be subject to the restrictions proposed in paragraphs 14.67 to 14.78 including rigorous restrictions on advertising by the non-conventional funds in accordance with paragraph 14.77.

Other mutual funds would be subject to more liberal rules, and more use of advertising by them can make a significant contribution to public awareness of differences among mutual funds. To facilitate this objective, requirements of the Canadian Radio-Television Commission which presently restrict advertising for securities should be modified to permit advertisements for the shares or units of mutual funds to the extent permitted by or under the proposals in Chapter XIV.

10.40 Of particular importance to the proper implementation of the third method is the role to be played by the financial press. Not only are financial newspapers looked to by other newspapers for guidance on the way to deal with financial news, but as the educational programme takes effect potential investors are likely to look to the financial press for assistance in their decisions. Comparative analyses of mutual funds and similar information published in financial newspapers are, then, likely to have very considerable impact. In paragraphs 3.08 and 3.16 we criticize the present practice of such newspapers in ranking mutual funds by rate of return, often over comparatively short periods. Analyses should be prepared which take other factors into account, including investment objectives, sales charges, and management fees. When more adequate analyses become available, it would be appropriate for governmentally-sponsored educational programmes to refer to them, subject to appropriate qualifications to indicate that the analyses do not have official sanction. If the financial press does not develop such analyses, it may be necessary for government to do so.

10.41 The information which must be conveyed, if the three methods discussed above are to be successful, includes comparative data on sales charges and management fees. For that information to be effectively transmitted, it must be meaningfully disclosed on a properly comparable basis. This is readily accomplished with sales charges. Only one question of importance needs to be resolved. Sales charges are traditionally disclosed as a percentage of the amount paid by the purchaser, rather than of the amount invested in the mutual fund. The prevailing rate of sales charges is usually stated as 8.5% of the

amount paid. It could as well be stated as 9.3% of the amount invested, although the two rates are not exactly the same; 8.5% of the amount paid is actually 9.2896% of the amount invested.

10.42 We have had a number of suggestions made to us that sales charges should be required to be disclosed, in prospectuses and sales literature, as a percentage of the amount invested in the mutual fund rather than as a percentage of the amount paid by the purchaser. It is said that such disclosure would facilitate comparisons with stock exchange commission rates, and would better emphasize the significance of sales charges to the investor. It is, in our view, clear that the prospectus should contain information as to the meaning of the sales charge rate, and that its adequate explanation requires the use of both methods of expression. We have, however, concluded that a compulsory change in the prevailing method for the expression of sales charge rates in documents other than the prospectus is unnecessary.

10.43 Our principal reason for acceptance of the prevailing method for the expression of sales charge rates is that most mutual fund purchasers decide on a particular dollar amount rather than on a particular number of shares or units. Such purchasers can more easily compute the portion of their payment which will be absorbed by sales charges if the rate is stated as a percentage of the amount paid by the purchaser. The purchaser who has $1,000 available for investment and is told that sales charges are 8.5% of the amount he pays can quickly determine that he will pay $85 for sales charges and that $915 will be invested. If he is instead told that sales charges are 9.3% of the amount invested, he must calculate the amount invested, which will be a dollar figure that, when increased by 9.3%, equals $1,000. If P is the amount invested, the equation he would have to use for this calculation would be

$$\$1,000 = P + \frac{9.3}{100} P$$

P would, in fact, equal just over $914.90 rather than $915.

10.44 Apart from the fact that it would require purchasers to solve an equation in order to compute commission payments, we would be concerned for another reason about the compulsory adoption in Canada of sales charges computed

as a percentage of the amount invested. The practice in the United States is to state sales charges as a percentage of the amount paid by the purchaser, and it is inevitable that sales literature or other material concerning United States mutual funds will be read by at least some Canadians. Confusion concerning sales charges would inevitably result, and if the prevailing rates in the two countries remain the same it would be easy for the potential purchaser to be mislead into believing that the Canadian rate, stated as 9.3%, was higher than the United States rate, stated as 8.5%. Such a result would, in our opinion, be highly undesirable.

10.45 Disclosure of management fees on a comparable basis is a more difficult problem, because of the relationship between management fees and other management expenses. As noted in paragraph 10.15, management fees can in effect be increased through the allocation of a management expense to the mutual fund rather than the management company. Tables X-A and X-B sufficiently indicate both the disparity of practice in this area and the fact that variances between mutual funds are far greater when management fees are considered together with other management expenses than when they are considered alone. It is therefore essential that a system of disclosure designed to encourage comparisons among mutual funds include provision for management fee and expense comparisons on a basis that will not be affected by the allocation of expenses between mutual fund and management company.

10.46 We have considered whether it would be appropriate to prescribe by statute a basis for the allocation of expenses between management and distribution companies and the mutual fund, and have concluded that such a requirement would be unduly onerous. Instead, the stress for purposes of disclosure should be on the management expense ratio. This ratio should be calculated for any year by aggregating the management fee and all other management expenses (which would include all expenses except brokerage fees and other fees incurred in the completion of transactions and income taxes) of the mutual fund for that year and expressing the result as a proportion of average total net assets for the year. Average total net assets should be the average of the

total net assets of the mutual fund on all days upon which net asset value per share or unit was computed. The information so provided will furnish a far more valid basis for comparison among mutual funds than do management fee rates standing alone. It, rather than the management fee, should be the subject of emphasis in prospectuses and sales literature. In addition, we hope that the financial press will take advantage of its availability to assist in the preparation of the analyses referred to in paragraph 10.40.

10.47 To improve the comparability of management expense ratios, it is desirable for mutual funds to adhere to a uniform practice in the computation of management fees. The industry practice is uniform at present. Almost every Canadian mutual fund presently pays a management fee computed as a percentage of average total net assets, although in some cases the percentage is determined on a scale which decreases as total net assets increase, and in other cases the percentage varies with the quality of performance. Management fees that vary with the quality of performance are usually called incentive fees; in paragraphs 11.39 to 11.55, we conclude for reasons there stated that mutual funds should not be permitted to pay incentive fees. Other bases for computation of management fees are possible; they could, for example, be calculated as percentages of capital gains or income revenues. Most such alternative techniques would involve the investment managers in conflicts of interest, for they would be motivated to concentrate upon the type of revenue on which their compensation was based. This fact, combined with the desirability of uniform methods to facilitate comparisons of management expense ratios, and our conclusion for other reasons that incentive fees should not be permitted, has led us to conclude that management fees should be required to be calculated in all cases as a percentage of total net assets. It should be permissible for the percentage to be on a decreasing scale based on total net assets.

10.48 For the reasons set out in this section, we recommend:

(1) that the knowledge necessary to enable potential purchasers to compare mutual funds should be communicated to them:

(a) through regulations concerning the content of material distri-

buted by salesmen, in accordance with recommendations in paragraph 14.79;

(b) through educational programmes financed, to the extent necessary, by government; both federal and provincial governments should accept such programmes as a responsibility to contribute to the effective investment of savings and thereby to the welfare of individuals and of the national economy; and

(c) through the press and other communications media, including radio and television; advertisements for mutual funds should be permitted subject to compliance with recommendations in paragraph 14.79 and the regulations of the Canadian Radio-Television Commission should be amended accordingly;

(2) that the financial press should be encouraged to prepare comparative analyses of mutual funds which properly reflect quality of investment management, sales charges, management fees and other relevant factors in order to enable purchasers to base their selections on adequate comparisons; if the financial press fails to prepare such analyses, the task is sufficiently important to justify its performance by government;

(3) that no change should be required in the prevailing practice whereby sales charge rates are expressed as percentages of the amount paid by the purchaser, rather than as percentages of the amount invested, but that the latter figure should be included in prospectuses for explanatory purposes; that emphasis for disclosure purposes should be placed on the management expense ratio rather than on the management fee; the management expense ratio for a year should be calculated by expressing

the aggregate of the management fee and all other management expenses (which would be all other expenses except brokerage fees and other fees incurred in the completion of transactions and income taxes) for that year as a proportion of the average total net assets for that year (which would be the average of the total net assets of the mutual fund on all days upon which net asset value per share or unit was computed in that year); and

(4) that management fees paid by mutual funds should be required to be calculated as a percentage of average total net assets; the relevant percentage could vary on a prescribed scale with the average total net assets of the mutual fund.

Recommendations Concerning Retail Price Maintenance

10.49 Successful implementation of the recommendations in the preceding section should result in a considerable increase in the pressure on sales outlets, including brokers, independent sales forces and direct sales forces to reduce their portion of sales charges in order commensurately to reduce the price to the purchaser. Such pressure is a natural development in a competitive market. It is of considerable concern to distribution companies, which attempt to avoid its consequences through the techniques described in paragraphs 2.52 to 2.57. If the distribution is through a direct sales force, the distribution company simply prohibits salesmen from rebating any portion of their compensation to the purchaser.

10.50 In the case of independent sales forces and brokers, the distribution company has agreements or understandings with them that they will not reduce their compensation in favour of the purchaser. Distribution companies that rely on these distribution techniques are constantly concerned with price-cutting, and will usually refuse to accept sales orders from a broker or independent sales force that will not enter into such an agreement or understanding, or is suspected of violating it. The objective of these agreements or understandings is to prevent the development of price competition among sales outlets, and we have concluded that they should be prohibited. This conclusion

is of considerable importance and we have discussed it at length with representatives of a number of distribution companies. Most have expressed opposition to the suggestion; indeed, the Canadian Mutual Funds Association has taken exactly the opposite position. It proposes that the agreements or understandings should not only be permitted, but should be enforced by statute. This is the position in the United States under section 22(d) of the Investment Company Act of 1940. In view of the importance of our conclusion it seems desirable to review the arguments advanced by industry representatives.

10.51 Agreements similar to those here being considered are well known in connection with the distribution of any item that is sold through a number of outlets not directly under the control of the principal distributor. The practice of entering into such agreements is referred to as "resale price maintenance" or "retail price maintenance". The former term is generally used in Canada because the specific prohibition in section 34 of the Combines Investigation Act* relates only to cases of resale. The section is restricted to articles or commodities, and we have been advised that it is unlikely the courts would consider mutual fund shares or units to be either articles or commodities. Even if the section were applicable to mutual funds, it would be insufficient for our purposes, since in many cases the legal relationship between the distribution company and the broker or independent sales force is that of principal and agent (or agent and sub-agent, if the distribution company is itself agent of the mutual fund) and the sale by the broker or independent sales force to the purchaser is therefore not a resale. For that reason, the wider term "retail price maintenance" is used in the following discussion. Following the consideration of the industry's arguments, we discuss in more detail the legislative provisions that would be necessary to implement our conclusions.

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* R.S.C. 1952, c. 314, as amended. The section reads as follows:

34. (1) In this section "dealer" means a person engaged in the business of manufacturing or supplying or selling any article or commodity.

(2) No dealer shall directly or indirectly by agreement, threat, promise or any other means whatsoever, require or induce or attempt to require or induce any other person to resell an article or commodity

(a) at a price specified by the dealer or established by agreement,

10.52 Some of the arguments advanced by industry representatives in support of retail price maintenance have, in our opinion, considerable cogency. Those that impress us are based on the fact that the distribution of mutual fund shares or units involves important differences from the distribution of consumer

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(b) at a price not less than a minimum price specified by the dealer or established by agreement,

(c) at a markup or discount specified by the dealer or established by agreement,

(d) at a markup not less than a minimum markup specified by the dealer or established by agreement, or

(e) at a discount not greater than a maximum discount specified by the dealer or established by agreement,

whether such markup or discount or minimum markup or maximum discount is expressed as a percentage or otherwise.

(3) No dealer shall refuse to sell or supply an article or commodity to any other person for the reason that such other person

(a) has refused to resell or to offer for resale the article or commodity

(i) at a price specified by the dealer or established by agreement,

(ii) at a price not less than a minimum price specified by the dealer or established by agreement,

(iii) at a markup or discount specified by the dealer or established by agreement,

(iv) at a markup not less than a minimum markup specified by the dealer or established by agreement, or

(v) at a discount not greater than a maximum discount specified by the dealer or established by agreement; or

(b) has resold or offered to resell the article or commodity

(i) at a price less than a price or minimum price specified by the dealer or established by agreement,

(ii) at a markup less than a markup or minimum markup specified by the dealer or established by agreement, or

(iii) at a discount greater than a discount or maximum discount specified by the dealer or established by agreement.

(4) Every person who violates subsection (2) or (3) is guilty of an indictable offence and is liable on conviction to a fine in the discretion of the court or to imprisonment for a term not exceeding two years or to both.

(5) Where, in a prosecution under this section, it is proved that the person charged refused or counselled the refusal to sell or supply an article to any other person, no inference unfavourable to the person charged shall

goods, in which the prohibition of resale price maintenance has long been accepted as a matter of policy. The first of these differences is the great importance of reliable sellers, who will not misrepresent the merits of the shares or units being sold, nor oversell the prospective purchaser. Similar arguments have frequently been advanced in the past in connection with various commodities, but we accept that they have particular force in the present context. Securities are intricate commodities, and it is reasonable that the distribution company should wish to retain more control over the identity of those actually engaged in the sale to the public. The distribution companies would be put in a difficult position if denied the ability to fulfill this wish, for in Chapter XIV we make a number of recommendations for the imposition of responsibilities on distribution companies and to carry out such responsibilities they must be able to prevent undesirable sales outlets from participating in public distribution.

10.53 The second problem of concern to us is distinctive to mutual funds. The obligation to redeem on demand by the holder makes it essential for the distribution company to retain control over the flow of shares or units. Proceeds of new sales are in large part relied on to provide the cash necessary to satisfy redemptions, and it is contended that in the absence of retail price maintenance, brokers and independent sales forces would be able to operate secondary markets within the spread between the sale price and the redemption price in the manner described in paragraph 2.56. A broker or independent sales

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be drawn from such evidence if he satisfies the court that he and any one upon whose report he depended had reasonable cause to believe and did believe

(a) that the other person was making a practice of using articles supplied by the person charged as loss-leaders, that is to say, not for the purpose of making a profit thereon but for purposes of advertising;

(b) that the other person was making a practice of using articles supplied by the person charged not for the purpose of selling such articles at a profit but for the purpose of attracting customers to his store in the hope of selling them other articles;

(c) that the other person was making a practice of engaging in misleading advertising in respect of articles supplied by the person charged; or

(d) that the other person made a practice of not providing the level of servicing that purchasers of such articles might reasonably expect from such other person.

force that engaged in this practice could accumulate a substantial long or short position in shares or units to execute orders, secure in the knowledge that the position could be readily liquidated. A long position could be liquidated by presenting the shares or units for redemption, a short position by purchases from the mutual fund, probably at a substantial discount from the sales charge ordinarily applicable. In either case, the marketing and investment arrangements of the mutual fund could be adversely affected.

10.54 While we are impressed by the arguments developed on the basis of the two distinctive factors outlined in the preceding paragraphs, we have concluded that retail price maintenance is not necessary to meet the points made. Instead, the development of secondary markets in mutual fund shares or units should be prohibited. Specific proposals to implement this conclusion are made in paragraphs 13.72 to 13.78. The implementation of these proposals would, in our opinion, constitute a complete answer to the various arguments based on the two factors referred to above. A broker or independent sales force would not be able to effect sales to the public without prior arrangements with the distribution company, and the distribution company would be a party to all transactions. As an additional precaution, we suggest below that the relevant legislation include a specific provision which would make the belief of the distribution company, on reasonable grounds, that the sales outlet intended to operate a secondary market sufficient justification for refusing to sell to or through that sales outlet.

10.55 The other arguments advanced by representatives of the mutual fund industry not only have failed to convince us that retail price maintenance should be supported by statute; they have equally failed to dissuade us from our conclusion, reached for the reasons stated earlier in this section, that retail price maintenance should be prohibited by statute. The argument which is perhaps most stressed is that in the absence of retail price maintenance different sales charges would be levied against different purchasers. This argument is stated as follows in a letter to us written on behalf of a

large mutual fund that distributes its shares through brokers and independent sales forces:

> [The writer] considers that equality of treatment of all shareholders and purchasers of mutual fund shares within the context of the prospectus, particularly in the area of offering price, is fundamental to the sound operations of a mutual fund. It can and indeed has been argued that unregulated competitive pricing of mutual fund shares is an advantage to the public. [The writer] is of the opinion, since few individual members of the public are in the same competitive position, that regulated, equal treatment with respect to pricing is a greater benefit, without which many investors, and particularly the smaller investor, may suffer substantial prejudice.

We disagree with this argument. The small purchaser is already discriminated against through the lack of availability to him of the sales charge discounts provided to large volume purchasers as described in paragraphs 2.18 to 2.20, and in our opinion more aggressive competition can in the long run only be of benefit to the small purchaser even though some purchasers may pay higher sales charges than others. After all, the right to bargain as to price is available with many items and the law does not ordinarily assume that unfairness is present if one person is able to obtain a better price than another.

10.56 A good example of our position on the argument relating to inequality of price is provided by the dispute over group discounts. Such discounts are another aspect of the recognition by the mutual fund industry that it is necessary to reduce the sales charge levied in sales to large volume purchasers. Many distribution companies grant the resultant discounts to purchasers who act as a group, by permitting each member of the group to pay only the percentage sales charge that would have been levied if purchases of all group members had been effected together. There has been considerable concern within the mutual fund industry over the willingness of some distribution companies to accept organizations as groups although their members have little connection among themselves. Professional associations, trade unions and others are within these categories. In its submission to us, the Canadian Mutual Funds Association suggested legislation that would embody a definition of "group" in order to avoid this practice. We are of the contrary view; to us, the practice is a desirable one, representing in a small way the beginning of a competitive

pricing structure that would benefit the small purchasers as well as the large purchasers. We think it likely that any reductions in sales charges which result from increased competition at the consumer level within the mutual fund industry will be initially manifested in an extension of such group discounts, and in the availability of volume discounts for purchases of dollar amounts that would not presently justify such discounts.

10.57 A somewhat similar argument has been given great stress by a number of industry representatives; a report prepared by consultants to the Canadian Mutual Funds Association described it as the "free ride" argument, "that a representative will spend a considerable amount of time explaining the attributes of mutual funds and then find that the client makes his purchase through a cut-rate plan or dealer". An accompanying footnote reads as follows:

> It has also been noted by members of the industry that potential clients often do not make a purchase from anyone after such a shopping exercise. We have no figures on the number of individuals so affected; however, it is a well-known and frequently observed psychological phenomenon and one that is <u>not</u> a part of traditional economic models. One writer has labelled the phenomenon "housewives' neuroses" and has exemplified two forms. "In the first Mrs. Jones knows that the same toothpaste is being sold at different prices in different shops. She goes round and round finding lower and lower prices, but can never bring herself to buy, just in case she sees a still lower price in a shop on the way home. In the second case, Mrs. Jones does buy, but when she sits down for tea with Mrs. Robinson, suffers agonies when she learns that the latter did find a lower price." G.D.N. Worswick, "On the Benefits of Being Denied the Opportunity to 'Go Shopping'", Bulletin of the Oxford University Institute of Statistics, Vol. 23 (1961), p. 278, note 3. Members of the Industry have told us that the "agonies" of learning of a lower price could result in a higher than otherwise level of redemptions and a general distrust of the industry. The possible extent of such effects would be very difficult to estimate.

This argument provides an excellent example of our differences of opinion with the industry representatives. The conclusion we have reached is that the great majority of mutual fund investors do not engage in a shopping operation; that for them shares or units are unsought goods. Mrs. Jones, in the second case in the quotation, behaves in the fashion that we think should characterize more purchasers; we do not, of course, think they should refuse to purchase, and we believe that the fears that this will occur are exaggerated.

10.58 Distribution companies that rely on brokers and independent sales forces, and distribution companies that rely on direct sales forces, have each argued that the prohibition of retail price maintenance would injure them at the expense of the other. We have little sympathy with the argument of the direct sales forces, that they would have to retain their sales charge structure at the same level in order to compensate their salesmen, and would lose customers to the brokers or independent sales forces that were cutting sales charges. Such an occurrence would be the surest possible indication that the present level of sales charges is too high. In fairness, we should add that not all distribution companies which rely on direct sales forces have advanced this argument; one major organization has expressed agreement with the argument, considered in the next paragraph, that the principal impact of the prohibition of retail price maintenance will be on brokers and independent sales forces rather than the direct sales forces.

10.59 The argument that prohibition of retail price maintenance would benefit distribution companies which rely on direct sales forces at the expense of those which rely on brokers and independent sales forces is of more concern to us. This argument is based on the claim that distribution companies which rely on direct sales forces can readily retain control over this single outlet and will be comparatively unaffected by the prohibition of retail price maintenance; as indicated below, we think that in the short term this claim will probably be correct. Distribution companies that effect sales through brokers or independent sales forces, on the other hand, have a number of sales outlets and their relationship to the outlets is not as close as is true with direct sales forces. Any one of such outlets might reduce sales charges to attract purchasers from the others, thereby perhaps precipitating a general decrease in sales charges for the mutual fund concerned.

10.60 The most noteworthy point concerning the argument described in the preceding paragraph is that it presupposes the occurrence of the very event that the prohibition of retail price maintenance is intended to facilitate: the reduction by one or more sales outlets of their portion of the sales

charge in order to reduce the price paid by the purchaser. It also assumes the development of awareness on the part of potential purchasers concerning the impact of sales charges so that they will put pressure on the sales outlets to reduce sales charges. Such pressure could take the form of direct demands for sales charge reductions, or at least for proof that the services rendered by the sales outlet are sufficient to justify its compensation; or could take the less direct but equally effective form of refusal to buy because sales charges are unjustifiably high. Such a level of awareness would be virtually equivalent to the level of knowledge and ability contemplated by paragraph 10.28. We think it unlikely that it will come to purchasers from whom mutual funds are unsought goods and who purchase from brokers and independent sales forces more quickly than it will come to those who purchase from direct sales forces. For that reason, any consequent reductions in rates would probably be quickly reflected in competitive pressure on the direct sales force organizations.

10.61 In spite of the points made in the preceding paragraph, we think it possible that the prohibition of retail price maintenance would result in at least a temporary competitive advantage to the direct sales forces. We have considered this question, and have decided that any disadvantages inherent in such an occurrence are far outweighed by the advantages in the prohibition of retail price maintenance. As noted in the next paragraph, we are not sure that the prohibition would result in a decrease of sales charges; they could remain at the present level, or increase. If brokers and independent sales forces must reduce their compensation, this is an indication that present levels of sales charges are too high. Second, by reducing their portion of sales charges and announcing the reduction to their clients, brokers and independent sales forces would hasten the educational process which is the objective of the recommendations in the preceding section.

10.62 Another reason for our rejection of arguments based on alleged competitive advantages for the direct sales forces is that, for reasons indicated in paragraph 10.70, it is possible that implementation of our recommendations may force a reorganization of the direct sales forces. Disadvantages in this reorganization might be sufficient to outweigh any competitive

advantage they might otherwise receive as a result of the prohibition of retail price maintenance. If these reorganizations are not effected, it is possible that direct sales force salesmen might also participate in price competition. For all these reasons, but primarily because of our belief that the prohibition of retail price maintenance is necessary for the development of effective competition, we have concluded that the prohibition should be implemented although it might temporarily put the direct sales forces in an advantageous competitive position.

10.63 The most interesting aspect to us of the arguments as to who would benefit from the prohibition of retail price maintenance is that each assumes that the introduction of competition with respect to sales charges would result in a reduction of sales charge levels. We make no such assumption; it could also be argued that the removal of the existing administrative constraints over sales charges would permit them to increase despite the prohibition of retail price maintenance. If it is correct that prohibition of retail price maintenance would bring about a reduction in sales charges, we think the following quotation from a commentary prepared for us by one of our consultants, Professor A. Breton, is relevant. With respect to the contention that prohibition of retail price maintenance would prevent adequate compensation of direct sales forces of the size presently used, he said:

> It is true that with price competition all sellers may not be able to sustain a sales force, but this only means that the difference between the size of the total actual sales force and that which would obtain under competition is in fact indirectly being subsidized by the excess of R.P.M. price over competitive price.

Another relevant point is that a decrease in sales charges might actually result in an increase in total sales. The exact effect cannot be known until the decrease occurs.

10.64 The final argument in favour of retail price maintenance is the one which has caused us most concern. This is that its prohibition would put the entire mutual fund industry, rather than a single segment of it, at a competitive disadvantage. Mutual fund salesmen would not be rewarded as well as would life insurance salesmen, so would be lost as mutual fund salesmen.

This argument, like those concerned with which segment of the mutual fund industry would be most affected by the prohibition of retail price maintenance, assumes that competition would reduce sales charges. It further assumes that the decrease will reduce total sales, or at least will not sufficiently increase them to make up for the loss in sales charges. We have reached no conclusion as to the merits of either of these assumptions. We recognize that if, and only if, each of them is correct, then competitive difficulties could result for the mutual fund industry. This possibility should not affect our recommendations. Our responsibility is to conduct a study of the mutual fund and investment contract industries; a recommendation that desirable innovations be withheld unless and until similar changes are made in the life insurance industry or the brokerage industry does not fall within our purview.

10.65 Our rejection of the arguments discussed in the preceding paragraph need not be based on the reasons there stated; we would not accept those arguments even if we had authority to do so. The two assumptions on which the arguments are premised, each of which must be present before the competitive disadvantage arises, may well be inaccurate. In addition, the increasing degree of overlap between the life insurance industry and the mutual fund industry, which we recognize with our conclusions in Chapter XIV concerning dual licencing, would reduce the impact of any competitive disadvantage. That impact would be further reduced by implementation of the conclusions in Chapter XVI concerning variable insurance policies. For all these reasons, we would reject arguments against the prohibition of retail price maintenance which are based on the competitive position with the life insurance industry.

10.66 A number of technical problems must be resolved in the implementation of our conclusion that retail price maintenance in the distribution of mutual fund shares or units should be prohibited. The fact that it goes beyond the scope of the combines legislation presently effective in Canada because it relates to items that are not articles or commodities is not a serious difficulty. The conclusion can be implemented through a specific provision in legis-

lation applicable to mutual funds. A relevant precedent is to be found in the provisions of the Bank Act* relating to agreements concerning interest rates.

10.67 A more difficult problem concerns the form of the legislation itself. As noted in paragraph 10.51 the provisions of section 34 of the Combines Investigation Act, set out in the footnote to that paragraph, would be inadequate for this purpose even if that section applied to mutual fund shares or units. It is important to appreciate that the legislation we propose would not affect the portion of the sales charge retained by the distribution company, nor the sales charge rates specified in the prospectus. The sole objective is to require that the sales outlet which effects the actual sale be permitted to reduce its portion of the sales charge if it so wishes. This should be the case whether the relationship between distribution company and sales outlet is that of principal and agent, or of vendor and purchaser.

10.68 Our conclusion can be effectively implemented only through a legislative provision that prohibits any agreement between the distribution company and the sales outlets through which it effects sales, whether they purchase for resale or act as agents, if that agreement prevents the sales outlet from reducing its portion of the sales charge in order to produce a commensurate benefit to the purchaser. Not only should such agreements be made unenforceable, but it should be made an offence to enter into such an agreement either orally or in writing.

10.69 It is important that the relevant legislation should also include a provision with a purpose similar to subsection 34(5), set out in the footnote to paragraph 10.51. This provision would, in effect, indicate circumstances in which it would be appropriate for the distribution company to refuse to effect sales to or through a particular sales outlet. Each of the clauses of subsection 34(5) can be adapted for application in the mutual fund context. In addition, to carry out the prohibition of secondary markets, the provision should specify that the distribution company could refuse to sell to or through a particular sales outlet where it believed, on reasonable grounds,

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* Bank Act, S.C. 1966-67, c. 87, sec. 138.

that the sales outlet intended to operate a secondary market in the shares or units of the mutual fund concerned.

10.70 The proposed legislation would, technically, apply not only to independent sales forces and brokers, but also to direct sales forces, which invariably treat their salesmen as agents rather than as employees. The principal reason given for this policy is that the salesmen are thereby enabled to deduct their sales expenses in the determination of taxable income. While we think it unlikely that direct sales force salesmen would in practice voluntarily reduce their portion of sales charges the possibility exists that this might happen. The legislation may therefore have the indirect effect of forcing the distribution companies which rely on direct sales forces to decide whether to accept that possibility, or to reorganize and treat their salesmen as employees. This result seems to us perfectly appropriate. If, contrary to our expectation, direct sales force salesmen do agree with purchasers to reduce their portion of sales charges, this will be a desirable improvement in competition. If they are instead treated as employees, the distribution company would perforce find it necessary to maintain closer control over them, thereby contributing to the resolution of a number of the problems discussed in Chapter XIV.

10.71 We do not anticipate that implementation of our conclusions in this section will have a major immediate impact on the Canadian mutual fund industry. Any effect will arise only gradually, as the shopping goods segment of the market for mutual fund shares or units increases in size. This and, of even more importance, the prohibition of secondary markets will combine to avoid any adverse impact on orderly marketing of shares or units which might otherwise result from the prohibition of retail price maintenance. The arrangements should produce a gradual but continuous improvement in the quality of competition within the industry.

10.72 For reasons set out in this section, we recommend:

(1) that legislation applicable specifically to mutual funds should prohibit any oral or written understanding or agreement between a distri-

bution company and sales outlets through which it effects sales, (whether the relationship of sales outlet to distribution company is that of an agent to his principal or that of a purchaser to his vendor), if the agreement prevents the sales outlet from reducing its compensation on the sale of shares or units in order to produce a commensurate benefit to the purchaser; such agreements should be made unenforceable, and it should be an offence to enter into such an agreement;

(2) that the legislation contemplated by recommendation (1) should include a provision equivalent to subsection 34(5) of the Combines Investigation Act, specifying circumstances in which it would be permissible for a distribution company to refuse to effect sales to or through a sales outlet; such circumstances should include all those in subsection 34(5), with appropriate adjustments, and should also include cases where the distribution company believes, on reasonable grounds, that the sales outlet intends to operate a secondary market in the shares or units of the mutual fund concerned contrary to the prohibition of such markets recommended in paragraph 13.79; and

(3) that no exemption from the legislation contemplated by recommendations (1) and (2) should be provided for direct sales forces, but that such legislation should not apply to cases where the relationship of the distribution company to the sales outlet is that of an employer to his employee.

Interim Substantive Controls Over
Management Fees and Sales Charges, Apart from Contractual Plans

10.73 While we believe that implementation of the recommendations made in the two preceding sections will ultimately result in effective competition at the consumer level in rates of sales charges and management fees, we recognize that this result will not come about immediately. We have concluded that during the period prior to development of effective competition, substantive controls over sales charges and management fees will continue to be necessary. The analysis in Chapter II indicates that, unless constrained either by substantive controls or by effective competition, the upward pressures on sales charges and management fees would probably result in substantial increases, unjustified from an economic standpoint. That is the reason for the recommendations in this section; no implication is intended that the prevailing levels of management fees and sales charges are either "too high" or "too low". This section is confined to management fees and to sales charges on lump sum sales. The specific case of sales charges on contractual plans is considered in the next section.

10.74 Given that some form of substantive control is necessary for an interim period, the crucial question is what form it should take. We are reluctant to propose unnecessary changes in the existing regulatory structure, but we have concluded that the present comparatively rigid pattern of maximum fees and charges specified by securities administrators should be abandoned in favour of a new approach. One reason for this is that we think it desirable to introduce a higher degree of flexibility in this aspect of industry operations; so long as rigid constraints are imposed on sales charges and management fees, it is unreasonable to expect the development of true competition.

10.75 There are a number of reasons in addition to the desire for greater flexibility that have led us to conclude that fixed schedules of fees or charges should be abandoned. It is often helpful to consider management fees and sales charges together rather than separately, and a fixed fee structure could not do this without becoming excessively complicated. Another problem is that a fixed fee structure could not be fair in all situations. There is, for example, good reason to regard investment objectives and practices as relevant to the determination of the appropriate level of management fees and sales

charges. A fund on funds or a mutual fund that invests exclusively in bonds should, perhaps, pay a lower management fee than other mutual funds of the same size. A lower sales charge should, perhaps, be levied on the sale of shares or units issued by a mutual fund with very wide and flexible investment objectives and practices. These considerations could not feasibly be reflected in fixed rate structures, particularly since in the case of mutual funds which appeal to the unsought goods segment of the market the maximum rates authorized under such structures tend to represent the prevailing rates.

10.76 Our final reason for rejection of fixed fee structures is that they do not adequately allow for the exceptional case. During the period between 1964 and 1967, one of the most successful Canadian mutual funds judged by rate of return was Guardian Growth Fund Ltd. Although its total net assets during this period rose from $1,566,000 to $18,713,000 and its net asset value per share from $4.16 to $8.15, it was never qualified for sale in the province of Quebec because the management fee paid by it exceeded the 1% limit prescribed by the Quebec Securities Commission, referred to in paragraph 10.16. The mutual fund ceased distribution of new shares following the introduction of the Ontario Securities Commission ruling quoted in the same paragraph, with which it also failed to comply. We think it very important that any regulatory structure in such a sensitive area as this be capable of dealing with the exceptional case.

10.77 There are other requirements that should be satisfied by any procedure for substantive controls over sales charges and management fees. While we think it important to avoid a fixed schedule, we recognize that it would be neither possible nor desirable to resolve each case completely on its merits, independently of any guidelines. It is necessary, then, for an administrative authority to retain the power to shape the over-all policy in this area. However, we consider that the present situation under which each provincial administrator has authority to formulate a maximum rate schedule without regard for what is being done elsewhere is unfair to the organizers of any mutual fund that is to qualify for sale in more than one province. In practice, they must accept the most restrictive policy imposed by the administrators in the provinces where they propose to qualify. This problem would be avoided if legislation which im-

plements our recommendations were to be administered by a body with national authority, but for reasons indicated in Chapter XIX we anticipate that provincial administration will be necessary for at least an interim period.

10.78 Until the development of a national agency, the problem raised in the preceding paragraph can be best resolved through provincial administration but with a single right of appeal to the courts on a basis that would be nationally effective. The availability of such a right would also resolve a problem which has long troubled us, particularly those of us who are securities administrators. This is that administrative decisions on these questions are, under present practice, in fact unappealable. They are made on the basis that a prospectus will be rejected if the decision is not accepted, since this is the only available technique to enforce compliance. Yet to reject a prospectus is to deny the right to sell, a serious blow to an operating organization; and even if an appeal was successfully taken from the rejection, it would soon be necessary to apply for another filing. That application could also be rejected, necessitating a repetition of the entire process. This is an undesirable result, and we believe that a system of substantive controls should provide for a more meaningful appeal from the administrator's decision. A procedure that would resolve this problem and also ensure national uniformity of results would be highly desirable.

10.79 In Chapter VIII we conclude that each mutual fund which operates within a province should be required to register with the appropriate administrator in that province; of course, if national administration is arranged a single registration would be possible. The control over sales charges and management fees should, in our view, be associated with the registration rather than with prospectus filing. This will prevent evasion of the requirements through termination of distribution. Each administrator would create and apply policy concerning the levels of sales charges and management fees; general guidelines would be appropriate, but should be kept under continuing review. Hopefully, the various administrators will maintain close liaison and will cooperate in the development and application of guidelines. The administrator would have the right to challenge the level of sales charges or management fees at the time of initial registration of a mutual fund, or to raise the matter at

any later date while the registration remains in effect except during the period after a declaration of reasonableness had been made as contemplated by paragraph 10.82, and while that declaration remained effective.

10.80 A challenge by the administrator would result in discussions with the appropriate person in the mutual fund organization. Most challenges would be resolved through such discussions. If the mutual fund organizers found themselves in complete disagreement with the administrators, or if one or a few administrators took a more rigorous position than their colleagues in the other provinces, the mutual fund organization could have recourse to the courts. We have concluded that this recourse should take the form of an application for a judicial declaration that the sales charge or management fee under discussion was reasonable, rather than a formal appeal from the administrator's decision. Legal and other costs of such application should be borne by the management or distribution company rather than the mutual fund.

10.81 The exact effect of the application for judicial declaration would vary depending upon the circumstances in which the question arose. The following are the three catagories of circumstances that might occur:

(a) if the mutual fund had not previously been registered in the particular province, the application for its registration would not be accepted until the question of sales charges and management fees had been resolved; or, alternatively, it could accept a level of sales charges and management fees satisfactory to the administrator and proceed with the judicial application in accordance with the procedure in (b);

(b) if the mutual fund was currently registered in the particular province with levels of sales charges and management fees satisfactory to the administrator but proposed to increase them to a level not satisfactory to him, it would be permitted to retain its registration and to continue the sale of shares or units at the previous level of sales charges and management fees while proceeding with an application for a declaration as to the reasonableness of the proposed new level; or

(c) if the administrator decided that the level of sales charges or management fees for a currently registered mutual fund was too high, or if an

increased level was proposed but the administrator determined that even the existing levels were too high, the registration of the mutual fund would remain effective and it could retain its existing sales charge and management fee structure while proceeding with the application for a declaration as to reasonableness of the proposed charge and fee structure; this procedure would, for example, be appropriate if the administrator decided that a mutual fund which paid a management fee equal to a specified percentage of average total net assets had attained a size that resulted in economies of scale which should be passed on to the investor.

In no case should the mutual fund be permitted to state in its sales literature that the sales charges or management fees had been found reasonable, although a properly qualified statement that they could not be challenged while the order remained in effect would constitute relevant information for prospectus disclosure.

10.82 We have concluded that the court on such applications should have power either to declare that the sales charge or management fee level that forms the subject matter of the application is reasonable, or to refuse such a declaration. The court would not ordinarily be expected to determine what levels were reasonable, or to make a specific finding that the levels in question were unreasonable, although reasons for judgment might comment on these points. This would leave the matter to be negotiated by the mutual fund organization with the administrator or administrators concerned; if the application was unsuccessful and agreement could not thereafter be reached with the administrator, a new application could be commenced proposing a lower rate. The only exception to these statements would concern applications falling within category (c), if the court should refuse to find the levels currently in effect to be reasonable. In such cases, in order to permit continuing operation of the mutual fund, the court should have power to make a specific finding as to what would constitute reasonable sales charges or management fees. It should also have discretionary power to order the management company or distribution company, or both, to pay to the mutual fund money earned by it or them in excess of what would have been reasonable, computed from the time the application was

brought. That time would be very shortly after the administrator's position became clear, for only by making the application would the registration of the mutual fund be preserved.

10.83 Additional provisions would be needed in order to provide for the national uniformity of results which is perhaps the most important objective of the proposed procedure. A declaration of reasonableness made by the court in the province where the head office of the mutual fund is located, or in the province where it is organized if it is a trusteed mutual fund, should be effective for a period of a year in all provinces with legislation which implements this report. In Appendix "D" we explain in more detail the procedure that we propose would be followed on such applications, and provide references to other instances in which provinces have been prepared to adopt decisions made by the courts of other provinces.

10.84 The arrangements outlined above would provide the desired level of flexibility and would retain in the hands of administrators the broad authority to make policy, subject to appeals to the courts in specific cases. The arrangements would in addition allow for national uniformity of results and would provide the affected organizations with a meaningful right of appeal. Our conclusions bear certain surface similarities to proposals made by the Securities and Exchange Commission for controls over management fees in the United States, which proposals were strongly opposed by the mutual fund industry in that country. There are, however, a number of basic differences between the two, and we believe that these differences are sufficiently fundamental to make the grounds for industry opposition in the United States irrelevant to our proposals. One important difference is that under our proposals mutual fund organizations could only be required to make the judicial application as a result of a challenge made by the appropriate administrator; shareholders or unitholders would not have power to require that such an application be made. An even more important difference is that our recommended procedure contemplates no circumstance in which the distribution company or the management company could be required to refund money earned, with the narrow exception of a category (c) application and then only with respect to excess money earned from the date of the

application. Finally, the fact that the appropriate administrator would have authority to negotiate would add a considerable degree of flexibility to the arrangements.

10.85 Implementation of the procedures we recommend would result in the delegation of a new type of responsibility to Canadian courts. Such responsibility exists already in theory, for a mutual fund could appeal from a prospectus rejection based on the administrator's disapproval of the sales charges or management fee, but no appeal of this type has ever occurred. We are satisfied that the courts could effectively deal with applications of the type here proposed, provided that guidelines as to relevant factors are specified in the legislation. The decision would involve the application of statutory criteria to reach a conclusion on a specific set of facts, a task for which the courts are well equipped. We anticipate that comparatively few judicial applications will in fact be necessary, for the initial applications will result in decisions that will constitute adequate precedents for subsequent use.

10.86 The legislation should give the courts power to receive evidence concerning, and to consider, all matters relevant to the reasonableness of the sales charges or management fees in question. Even if the application concerns only one of the two - either sales charges or management fees - both should be considered. They are closely related both from the viewpoint of the distribution and management companies and from that of the investor. Even where the distribution company is separate from the management company the organizers look to the income from both in order to determine the profitability of the mutual fund operation, and many have told us that they are prepared to break even on the distribution activity so long as total net assets are thereby built up in order to increase the management fee. From the viewpoint of the investor, the two are as closely related: he may well be prepared to pay a higher management fee on an investment in a mutual fund with a low sales charge, or without sales charges. The matters to be considered by the court are, then, essentially the same on the two topics although certain questions are of more direct relevance to sales charges or to management fees.

10.87 The investment objectives and practices of the mutual fund will be relevant both to sales charges and to management fees. As noted in paragraph 10.75, the management fees rate appropriate for a fund on funds or a mutual fund which invests exclusively in bonds may be lower than those appropriate for other mutual funds of the same size. On the other hand, a mutual fund with very wide and flexible investment objectives and practices, such as a non-conventional fund which takes advantage of the liberality of the restrictions on investments for such mutual funds proposed in Chapter XII, may well be more attractive to investors than other mutual funds; this will be particularly true while the emphasis on rate of return continues, if the more liberal investment practices result in a high rate of return even over a short period. That would be a relevant factor to consider in an assessment of the reasonableness of sales charges; if a non-conventional fund appears to receive an undue competitive advantage by reason of the investment practices available to it, the administrator might be justified in the assumption that its sales charge rates should be lower.

10.88 The nature of the services rendered should be considered in some detail. In the context of sales charges, the extent and effectiveness of administrative services used in handling orders and keeping the customer informed would be relevant. Less stress should be given the time spent by the salesman in obtaining the order, for the time salesmen are prepared to spend will increase with the reward to be earned. In the context of management fees, a number of matters are relevant to the quality of services. One is the historical record of the mutual fund, and of other investment portfolios managed by the same persons; any other data which might indicate the ability of such persons; and, generally, any information comparative or otherwise that might assist to determine the worth of the advice rendered or to be rendered. The allocation of management expenses between the mutual fund and the management and distribution companies is also an important consideration.

10.89 Another item of particular relevance concerning management fees is the effect of size, in which connection it might be necessary to consider the particular mutual fund together with other mutual funds under common management. The factor of size might be relevant to establish economies of scale, or

to establish that expenses are unusually large relative to total net assets in a small mutual fund. We would hesitate to see the latter factor given full recognition, for presumably some risk should be involved in the organization of a new mutual fund, but it is desirable in the interests of shareholders or unitholders that management have enough resources to finance adequate research. In this connection, it would also be relevant to ascertain and to consider the fees paid for management of investment portfolios of comparable size in other situations. We have found a number of instances in which a management company levies a higher fee for the management of a mutual fund than for an investment portfolio of comparable size, and in a case where that was found to be true it would be a factor relevant for consideration.

10.90 Prevailing practices in the industry are of relevance concerning both sales charges and management fees. It is apparent that a rate which deviates significantly from industry standards should be subjected to greater scrutiny than one which conforms to those standards. Another factor relevant to both types of charges is the value of indirect benefits derived by the distribution company or management company by reason of its or their relationship to the mutual fund. If reductions occur in the minimum commission structure of the stock exchanges so that it is no longer profitable for brokers to supply in exchange for portfolio transactions the extensive investment advice upon which management companies now rely so heavily, an increase in the prevailing level of management fees might be necessary. Conversely, if a particular management company is found to rely almost exclusively on advice from brokers, it would be reasonable to conclude that its management fee should be comparatively low. If brokers or others who sell shares or units of a particular mutual fund are compensated by reciprocal business as described in paragraph 3.66, this might be regarded as having a negative impact on the appropriate level of sales charges.

10.91 We do not underestimate the difficulty of the type of analysis proposed in the preceding paragraphs. It is of particular importance that the courts take into account any factors, whether or not included in the list set out above, that make a particular case unusual or justify a result which differs from the norm. While their task will not be easy, we have concluded that it is

one which the courts are well qualified to perform. They will derive very considerable assistance in each case from evidence given by the mutual fund organization concerned and by representatives of the administrators who appear before them.

10.92 The substantive controls outlined in this section should be implemented for an initial period of five years, at the end of which a review should be conducted by the appropriate authority in order to determine whether the industry has attained a level of competition at the consumer level sufficient to justify the removal of the controls. This recommended period should not, of course, prejudice earlier removal of the controls if adequate competition develops within the suggested period.

10.93 For the reasons set out in this section, we recommend:

(1) that the appropriate administrators should be entrusted with responsibility for the maintenance of a continuing review over levels of sales charges and management fees; that in so doing they should not formulate fixed fee schedules but should be entitled to formulate general guidelines to assist in their consideration of specific cases; and that they should have the right to challenge the continued registration, or to deny a proposed registration, of any mutual fund the shares or units of which are sold subject to a sales charge regarded by the administrator as unreasonable or which pays a management fee regarded by the administrator as unreasonable;

(2) that where a challenge to the registration or continued registration of a mutual fund is made on the grounds indicated in recommendation (1), the distribution company or management company should be entitled, at its own expense, to apply for a judicial declaration that the sales charges or management fees in effect or proposed are reasonable;

(3) that applications such as are contemplated by recommendation (2) should have the following effects:

(a) if the mutual fund had not previously been registered in the jurisdiction concerned, it would be entitled to elect between postpone-

ment of registration pending the outcome of the application, or completion of registration (subject to satisfaction of the other preconditions to registration) on the basis of the lower sales charges or management fees acceptable to the administrator, subject to an increase if the application is successful;

(b) if the mutual fund had previously been registered in the jurisdiction concerned, but it was proposed to increase the level of sales charges or management fees to a rate not satisfactory to the administrator, its registration would continue in effect with the rate unchanged, subject to an increase if the application is successful; and

(c) if the mutual fund had previously been registered in the jurisdiction concerned, but the administrator decided that the applicable sales charges or management fees were too high, or if an increase was proposed but the administrator challenged the existing level, the registration of the mutual fund would remain unaffected and existing levels of sales charges or management fees would remain in effect pending the final outcome of the application;

(4) that in the cases contemplated by clauses (a) and (b) of recommendation (3) the court would only have power to declare the effective or proposed sales charges or management fees to be reasonable or to refuse such a declaration; in the case described in clause (c) of recommendation (3), the court would have these powers and would also have the further power in the event that it refuse a declaration of reasonableness, to determine what would constitute a reasonable rate and to require the distribution company or the management company to refund to the mutual fund an amount equal to that by which the money earned since the commencement of the application exceeds what would have been earned if only a reasonable rate had been charged;

(5) that, in the event the relevant legislation is administered provincially, a decision of the courts in the province where the head office of the mutual fund is located (or, if it is unincorporated its province of

organization) should be effective for a period of one year in all provinces with uniform legislation;

(6) that the procedures to be followed in connection with the application should be substantially as contemplated by Appendix "D";

(7) that the court on the hearing of the application should have power to receive and to consider evidence on all matters relevant to the sales charges or management fees under consideration, including the extent to which they reflect prevailing practices in the Canadian mutual fund industry. All of the following matters should be considered although they should be accorded appropriate emphasis depending upon whether the application relates to sales charges or to management fees:

  (a) the investment objectives and practices of the mutual fund. Those which impose a comparatively small burden on management may make lower management fees appropriate. Those which are conducive to higher sales, as for example the wider investment practices available to a non-conventional fund as proposed in Chapter XII, may make lower sales charges appropriate;

  (b) the nature of services rendered by the distribution company and the management company; allocation of management expenses between the mutual fund and the management and distribution companies would be a relevant factor here;

  (c) the quality of services, judged by such matters as the court deems relevant, including but not limited to the past record of the mutual fund concerned, of mutual funds under the same management, and of other investment portfolios under the same management; and any other information which might assist in a determination of the worth of the services to be rendered;

  (d) whether the mutual fund, alone or together with other mutual funds under common management, is of a size such that the management company may expect to realize significant economies of scale;

  (e) the prevailing charges for management of other types of investment portfolios, and the prevailing rates of sales charges; and

(f) the scope and nature of the contribution made by the mutual fund, either directly or indirectly, to the management and distribution functions apart from the management fee and direct expenses;

(8) that in no case should sales literature of a mutual fund be permitted to include a statement that the sales charges or management fees had been found reasonable, although a properly qualified statement that they could not be challenged while the order remained in effect would be appropriate for inclusion in prospectuses; and

(9) that the legislation contemplated by the preceding recommendations should be in effect for an initial period of five years, after which it should be reviewed and the necessity for it reconsidered in light of the degree of competition in sales charges and management fees then prevailing at the consumer level within the mutual fund industry; if an adequate degree of competition becomes apparent in less than five years, the legislation should be reconsidered at such earlier time.

Interim Substantive Controls
Over Contractual Plans

10.94 In paragraphs 2.22 to 2.31 we describe the contractual plan method of investing in mutual funds. Only a brief summary of that discussion is necessary here. By the term "contractual plan" we mean any periodic payment plan for the purchase of mutual fund shares or units under which the amount deducted for sales charges from payments made during an initial period is greater than it would be if the same total amount of sales charges were evenly deducted throughout the life of the plan. Contractual plans differ considerably in detail. For analytical purposes, they can conveniently be divided into prepaid sales charge plans and traditional contractual plans. Under the former, which are less common than the latter, the planholder makes an initial payment no part of which is immediately applied to the acquisition of shares or units; instead, the entire payment is retained by the distribution company and is applied to increase the amount of subsequent payments over a specified period,often the full life of the plan. If the planholder fails to complete the plan, he sacrifices any portion of the prepaid amount not previously credited to purchases of shares or units.

10.95 Under the traditional contractual plans, a portion of every payment is immediately invested in the mutual fund but for a specified number of initial payments the amount deducted and retained by the distribution company as sales charges is higher than the average percentage to be deducted from all payments; correspondingly, after the initial period the percentage is lower. The precise terms vary considerably, but most provide for the deduction during an initial period of the maximum amount permitted under the policies applied by securities administrators, of which an example is provided in paragraph 10.14. The planholder who fails to complete his plan loses a disproportionate portion of his payment by way of sales charges; assuming no change in the value of shares or units purchased, the longer the planholder continues his payments past the initial period the less is his proportionate loss. Under each type of plan, the excess of the sales charges paid in an initial period over what they would have been if sales charges were evenly spread is referred to as a front-end load.

10.96 The principle of the contractual plan is that a disproportionate amount of sales charges is allocated to an initial period. It does not necessarily involve any increase of sales charges over what they would be if the purchase were effected as a single transaction. In spite of this, we are aware of no distribution company that offers a contractual plan under which the amount deducted from the planholder's total payments does not exceed what would have been deducted if the entire transaction had been effected as a single purchase. One reason is that in only a few cases does the contractual planholder receive the benefit of any volume discount which would be available if the total amount paid under the contractual plan were applied to a lump sum purchase. A more important reason is that service charges are invariably added to the sales charges and increase the total deduction. This is contemplated by the memorandum quoted in paragraph 10.14, which permits a maximum total deduction of 12% "of the value of the contract", taken to mean the amount the purchaser promises to pay.

10.97 The contractual plan as a distribution technique results from the need felt by salesmen to receive their compensation for the sale of a periodic payment plan as expeditiously as possible. For the same reasons that produce the upward pressure on sales charges generally, the distribution companies which effect sales through contractual plans are forced by the anomalous competitive situation to acquiesce so far as possible to this need, and therefore to maintain front-end loads at the maximum levels permitted by administrators. Successful implementation of the proposals in this chapter which are designed to end the competitive anomalies and to introduce effective competition at the consumer level should affect contractual plans. That will, however, occur over a comparatively long term and it is necessary to consider what controls should be applied to contractual plans during the interim period. The questions to be resolved are whether the controls proposed in the preceding section would be adequate for the purpose and, if not, what additional controls are necessary.

10.98 To resolve the questions here being considered, it is important to determine why contractual plans are used as vehicles for mutual fund investments. The answer from the viewpoint of the distribution company and the salesman is stated in the preceding paragraph. It is less clear from the viewpoint of the investor. If he fails to complete, he will pay a disproportionate amount of sales charges. Even if he does complete the plan, the impact of service charges will result in the deduction from his payments of more than would have been the case if he had paid the same total amount in one or more lump sum payments rather than under a contractual plan. These statements do not allow for fluctuations in the value of shares or units purchased, but they will often or usually be more true rather than less true if such allowance is made. It is reasonable to assume,for analytical purposes, that a mutual fund investment will earn a positive rate of return. Accepting this assumption, the front-end load can only reduce the return earned over the life of the plan, since the money deducted as front-end load does not work for the planholder as long as it otherwise would. The excess of the front-end load over a sales charge deducted at an even rate would be working for the purchaser from its time of payment if he selected another method of investment than the contractual plan.

10.99 In paragraphs 2.31 and 2.32 we discuss the reasons which would justify a contractual plan from the purchaser's viewpoint, and arrive at no satisfactory explanation; the argument that contractual plans promote forced savings, because the planholder who has made his initial payments is aware that he must continue payments in order to reduce his rate of sales charges, is postponed for discussion in this section. Closely related to the forced savings argument is the claim that many mutual fund investors are persons on regular incomes who are accustomed to purchase on the instalment plan and find it convenient to write cheques on a monthly basis. Apart from these arguments, we are aware of no reason to justify the acceptance by the purchaser of the financial disadvantages described in the preceding paragraph. Unless these two arguments constitute an adequate explanation, the success of contractual plans can only be explained as a manifestation of the fact that purchasers in the unsought goods segment of the market for mutual fund shares or units do not compare alternatives.

10.100 The two arguments which might explain contractual plan investments, that they encourage forced savings and that they are designed to appeal to the investor who is accustomed to instalment plan purchases, have been alluded to frequently by participants in the mutual fund industry during conversations with us and with our staff. We recognize some logic in these arguments, but very much doubt their adequacy to explain contractual plan investments. A purchaser could accumulate monthly cheques until he had enough to effect a lump sum investment, and would thereby in many or most cases substantially increase his rate of return. It is doubtful that an investor who wished to save on a periodic payment basis would deliberately, with knowledge that this alternative is available and of the implications of each alternative, select a contractual plan as his investment vehicle. Our doubts are accentuated by the results of the consumer survey conducted under our auspices. Present holders of contractual plans and former holders of contractual plans who had redeemed their holdings were asked about the level of sales charges as percentages of their total investment and as percentages of payments made in the first year. Of present holders of contractual plans, 57.2% said they did not know in what percentile

range the sales charges would fall as percentages of total payments and 44.7% said they did not know in what percentile range the deductions during the first year would fall as percentages of payments in that year. Corresponding figures for holders of contractual plans who had redeemed were 66.2% and 51.3% respectively. In both cases, only a small portion of those who said they knew the relevant information gave answers in the correct percentile ranges. These statistics are difficult to reconcile with careful analysis of alternatives prior to the investment decision.

10.101 Supporters of contractual plans do not, generally speaking, contend that careful analysis is done by potential planholders. Rather, it is said that such purchasers make their decisions on the basis of their long-term objectives and their monthly saving ability, with little regard for alternative methods of investment. On this argument, the contractual plan is justified by the fact that it is tailored for small, regular investors and provides the necessary (and expensive) administrative services required to process the cheques received from such investors and to send them statements. Most industry representatives acknowledge that a periodic payment plan without a front-end load could be equally well tailored for the small investor. They contend, however, that it would be less effective because it would lack the forced savings element unless a redemption fee or similar charge was applied as under the variant of the contractual plan discussed in paragraph 2.27, and because it would be more difficult to compensate salesmen so that they could afford the time necessary to effect sales to persons who are only able to make small monthly payments. We have been told that, in the absence of contractual plans, such persons would never invest in mutual funds at all, with resultant loss to themselves and to the economy.

10.102 The assumption that many contractual plan purchasers would not purchase but for the work of salesmen is, in our opinion, correct. It reflects our concept of the unsought goods segment of the market for mutual fund shares or units. However, there must be some limit on the extent to which the salesman should be compensated from the proceeds of sale for the trouble in effecting a difficult sale. Ordinarily the limit would be imposed by competition, but that is not an operative restraint in the present situation. In a determination

of the appropriate limits on front-end loads, and of the relevance of the forced savings argument, it is helpful to review the actual financial experience of contractual planholders. We collected detailed information on the Canadian experience under contractual plans sold in March, 1964, a date selected as sufficiently current that the sales made could be taken as representative of existing practice but as sufficiently long past to provide an adequate indication of experience. Of 2,623 plans studied which were sold by the larger distribution companies (these were not all the plans sold in that month by such companies since some supplied information on the basis of an extensive random sampling), 831 or 31.7% were redeemed prior to December 31, 1967 or within 46 months. These results indicate unsatisfactory experience under most contractual plans, a conclusion which is confirmed by experience under those plans which were not redeemed. Of the 1,792 plans in force at December 31, 1967, only 819 or 45.7% (being 31.2% of the original 2,623 plans) were paid up to date. Holders of the remaining 973 plans were behind in their payments: 373 (38% of the 973 plans or 14.2% of the plans originally sold) by 23 or more months; 197 (20% of the 973 plans or 7.5% of the plans originally sold) by 12 or more but less than 23 months; and 403 (42% of the 973 plans or 15.4% of the plans originally sold) by less than 12 months.

10.103 Other data collected by us supported or were consistent with our general conclusion that the average experience under contractual plans is unsatisfactory. For example, the statistics on experience with plans sold by smaller distribution companies show that, of 361 plans studied which were sold in March, 1964, 110 or 30.5% had been redeemed by December 31, 1967, by comparison with 31.7% of those sold by large companies. Only 80 or 22.2% had payments made up to date, as compared with 31.2% for the plans sold by the larger companies. This information and that provided in preceding paragraphs does not allow for fluctuations in the value of shares or units acquired, but in our opinion that does not reduce the value of the information; this is particularly true in view of the fact that, as noted in paragraph 10.98, allowance for fluctuations in value of shares or units would probably make the experience of the planholder seem even worse by comparison with that of a purchaser who effected a series of lump-sum purchases. It is also of interest that in our con-

sumer survey of former holders of contractual plans who had redeemed, 58.5% reported that on redemption they received less than total payments made, and only 21.1% reported that they received more than total payments.

10.104 Our factual conclusion concerning contractual plans is, then, that experience under them is unsatisfactory on the average and that a purchaser who compared the available alternatives would probably not select this method of investment. As the programme of public education contemplated by paragraphs 10.33 to 10.47 increases the quality of consumer choice, it is reasonable to assume that the use of contractual plans will decline. Whether or not that occurs, competition at the consumer level will be an effective constraint on the level of the front-end load and regulatory controls will be unnecessary. That leaves open the question of the controls appropriate during the interim period prior to development of a satisfactory competitive environment.

10.105 We have concluded that controls of the type proposed in the preceding section for basic sales charge rates would be inadequate for contractual plans. Those controls are designed to deal with the quantum of sales charges rather than with the manner in which sales charges should be collected. More importantly, they are not based on any affirmative finding that basic sales charge rates are "too high" or "too low". Rather, they are designed to assist competition to operate in order to determine the appropriate rates. The data we have collected on actual experience of contractual planholders are sufficient to convince us that the front-end loads currently charged are too high, a conclusion which not only justifies but necessitates more rigorous substantive restrictions than those proposed in the preceding section.

10.106 The question which must be initially resolved is whether contractual plans should be prohibited. We have concluded that, except in one class of cases, this would be too drastic a remedy; the exception is that the sale by contractual plan of shares or units of the non-conventional funds proposed in Chapter XII should be prohibited. While comparisons with sales techniques in other industries such as life insurance cannot be accepted to

prevent us from proposing requirements that we think appropriate for application to mutual funds, it is relevant that the prohibition of contractual plans for investment in conventional funds would put mutual fund distribution companies at a serious competitive disadvantage by comparison with life insurance companies. This is not true with non-conventional funds because the segregated funds of life insurance companies lack the flexibility of investment practices that will be available to non-conventional funds. Another reason to permit contractual plans for conventional funds is that there is merit to the contention that the salesman must be compensated for his time; within limits, it should be recognized that the effort involved in a sale to a person who purchases by a periodic payment plan is worthy of recognition. In the absence of effective competition, the limits are that the extent of the compensation should not be such as to make the purchaser's experience unsatisfactory. Finally, it may be, in spite of our doubts, that the forced savings argument is of attraction to some purchasers; again, however, that is not sufficient to justify a front-end load so large as to result in unsatisfactory investor experience. None of these reasons is persuasive with non-conventional funds, since one objective of the proposals made in paragraphs 12.30 to 12.39 is to minimize the sale of such mutual funds to purchasers for whom they are unsought goods.

10.107 The decision that experience under contractual plans must be improved but that such plans should not be prohibited for conventional funds makes it necessary to find another approach. Perhaps the most obvious way to improve the experience of planholders would be to restrict sales to persons who may be relied upon to complete the plan; it is the planholder who fails to complete who suffers most from the front-end load. We have considered what techniques would be appropriate to avoid sales to persons who will not complete their plans, and we requested our consultants in this area, Professors Dell'Aniello and Lefrancois, to do the same. We agree with their conclusion: "it would appear virtually impossible for even the best salesman to distinguish early redeemers from those who are likely to complete their plan at time of sale."

10.108 In this report we make a number of recommendations designed generally to hasten the development of competition at the consumer level; the competition should affect the terms of contractual plans as well as basic sales charge rates. Perhaps most important are the proposals in Chapter XIV, particularly those designed to encourage the purchaser to review his decision within the available rescission rights period. In addition, in paragraphs 14.45 to 14.48 we propose that distribution companies should be required to establish a review procedure so that verification from the purchaser could be obtained before a contractual plan was sold to a person for whom it seemed unsuitable. While these proposals should be beneficial in the avoidance of the sale of contractual plans to those few purchasers who will obviously be unable to complete, they will not resolve the inability to detect other purchasers who will fail to complete their plans. We have therefore concluded that substantive controls over front-end loads must be imposed during the period prior to development of effective competition.

10.109 It is impossible to determine analytically what size of front-end load should be regarded as the maximum permissible. The decision is one of judgment, based on knowledge of the current situation. On the basis of our study of the mutual fund industry, of the terms of contractual plans, and of the experience under contractual plans, we have concluded that the maximum permissible deduction for sales charges during the initial period of a traditional contractual plan should not exceed 30% of payments made. This figure does not include service charges, which are separately discussed below. It is designed to result in more satisfactory experience without amounting to a prohibition of their use.

10.110 The 30% figure is only the starting point of an adequate regulatory scheme. The regulations must also indicate how that figure relates to over-all deductions from the payments made under the traditional contractual plan, and what rules should restrict the allocation of deductions after the initial period. It is desirable, subject to the general restriction on the size of front-end loads, to preserve maximum flexibility for distribution com-

panies to create contractual plans in the forms they prefer, and the suggestions made in following paragraphs are shaped with that objective in view.

10.111 To be consistent with the principle of the contractual plan, that it affects the manner in which sales charges are collected rather than the total amount of sales charges, the amount deducted as sales charges over the life of a contractual plan should not be greater as a percentage of total payments than the basic sales charge rate of the distribution company concerned. That rate would, of course, be affected by the controls described in the preceding section, so that the proposals in this section should be considered together with those controls rather than separately from them.

10.112 We have considered whether distribution companies should be required to extend to contractual planholders the benefit of volume discounts such as those under the rate schedule quoted in paragraph 2.18. For example, under that schedule the basic sales charge rate is 8.5% of the amount paid by the purchaser, and the rate on sales between \$5,000 and \$15,000 is 8%. While we would think it highly desirable for the benefit of the volume discount to be extended to the contractual planholder whose plan contemplates total payments in excess of \$5,000, we have concluded that this should not be required. Because contractual plans impose no enforceable obligation on the purchaser to complete, there would be no certainty that the \$5,000 minimum purchase would be made. Even if this certainty did exist, such purchases are not of the type which resulted in the introduction of the volume discount scheme; to require that the advantages of the reduced rates be extended to contractual plan purchasers might constitute an artificial constraint on volume discounts. That would be particularly serious if, as we anticipate may be the case, increased competition is first manifested in liberalization of the volume discount arrangements through their extension to smaller purchases.

10.113 The restriction of deductions for sales charges to 30% of payments during an initial period would, in the absence of a definition of the initial period, leave open the possibility that sales charges would be deducted at the maximum rate until all the charges to be levied during lifetime of the

plan had been deducted. Such an arrangement might result in even worse experience under contractual plans than that under the plans we have studied. We have concluded that the initial period should be restricted to thirteen instalments. Since instalments are ordinarily paid monthly, and since two are ordinarily collected in the first month, a thirteen-instalment initial period would ordinarily equate with the first year of the life of a traditional contractual plan. For a further twelve instalments, the maximum deduction permitted for sales charges should be 15% of payments made by the purchaser. The sales charge unpaid after the first twenty-five instalments should be spread evenly over the remaining payments. The exact effect of these provisions will vary considerably depending upon the term of the traditional contractual plan, but we think that the results will be acceptable in all situations. To provide flexibility, the relevant provisions should allow other allocations of sales charge deductions, subject to two restrictions. The first restriction is that the percentage of total payments deducted should at no time during the life of the plan exceed the maximum amount permitted to be deducted up to that time under the rules outlined above. The second restriction is that the sales charge deducted from a payment should never exceed the percentage deducted from a prior payment.

10.114 The provisions outlined in the preceding paragraph would allow wide latitude in the formulation of traditional contractual plans designed to appeal to purchasers; as competition develops, distribution companies will be able to take advantage of the right to allocate sales charges in other ways, in order to spread the front-end load over a longer period. The restrictions are, however, tailored specifically to the traditional contractual plan and do not allow for the prepaid sales charge plan. We have concluded that the latter type of plan should also be permitted, subject to appropriate restrictions. The collection of an undue portion of total sales charges at the outset would be inconsistent with the intent of the proposals made in preceding paragraphs, as would the retention by the distribution company of sales charges attributable to payments not yet made after the purchaser terminates the plan.

10.115 To allow for the prepaid sales charge plan, a distribution company should be permitted to establish a contractual plan in accordance with the restrictions outlined above for traditional contractual plans, but to collect as an initial sales charge payment an amount not in excess of 30% of the first thirteen instalments to be paid under the contractual plan. This initial payment should be set up on the books of the distribution company as a liability to the purchaser, and should be credited to him by being added to subsequent instalments paid under the plan. The additions should be in equal amounts and the number of instalments over which they are credited should not exceed the number of instalments for which sales charges were collected on a prepaid basis. If the prepayment equals the sales charges deductible from the first thirteen instalments, it should be credited back over no more than thirteen instalments; if it equals the sales charges deductible over ten instalments, it should be credited back over no more than ten instalments.

10.116 Logically, it might be expected that the size of the instalments paid by the holder of a prepaid sales charge plan while the initial payment was being credited back should be reduced by the amount being credited. This would mean that with a contractual plan that carried $20 monthly instalments, under which a prepaid sales charge of $78 was taken, the first thirteen instalments would be $14 and the remaining instalments would be $20. Such a procedure would, however, be inadvisable since contractual plan purchasers usually budget for regular payments equal in amount, and a sudden increase in the size of payments during the term of the plan might be inconsistent with their budgetary arrangements. In addition, some concession should be made by the distribution company in view of the fact that it obtains the use of the initial payment for an extra period of time. The prepaid sales charge would provide it with immediate use of money some of which would not otherwise be available to it until the thirteenth instalment. We have therefore concluded that the initial payment, when credited back to subsequent instalments, should not be subject to sales charges. As the example in paragraph 10.121 indicates, this would facilitate the payment of equal instalments throughout the life of the prepaid sales charge plan.

10.117 If the holder of a prepaid sales charge plan ceases payments before the full amount of his initial payment has been credited to subsequent instalments, the distribution company should be required to pay him, in cash, the portion of the initial payment not so credited. In order to ensure that the planholder is aware of his rights, the distribution company should be required to advise him of them in writing at any time during the initial period when he becomes more than six payments in default. He should be given the option to continue payments or to receive the portion of his initial payment not added to subsequent instalments upon surrender of the plan either through conversion to a paid-up certificate or through redemption of his purchased shares or units.

10.118 The proposals in preceding paragraphs relate exclusively to sales charges and do not take into account other deductions from contractual plan payments. The most important of such deductions are service charges, which increase the percentage deducted over the lifetime of many plans from about 8.5% to about 11-12% of the amount paid. These must be considered in the regulatory scheme. It is understandable that they should be charged because the expense involved in the administration of a plan under which small monthly payments are made can be substantial. However, they could be used as a technique for the evasion of other limitations.

10.119 We have concluded that two restrictions should be applied on service charges levied under contractual plans, both prepaid sales charge and traditional. The first is that they should be deducted uniformly from all payments to avoid any front-end load or prepayment effect. The second is that there should be a specific maximum limit on the amount of service charges under contractual plans. This limit should be determined from time to time by regulation, in order that it may be adapted to changing costs; the determination should be made to reflect the fees of the custodian which assumes the responsibilities proposed in paragraphs 8.52 to 8.63 and other costs of administration, but not to allow an extra profit for the management company. We propose that the relevant limit be established, at the outset, at $1.00 per payment or 2% of the amount of the payment (including sales charges) whichever is less. This

proposal would not affect service charges for items not directly related to the contractual plan, such as reinvestment of dividends. Nor would it affect the amount paid for other benefits, such as completion insurance.

10.120 Our proposals concerning the regulation of contractual plans during the period prior to the development of effective competition at the consumer level can be illustrated by the example of a contractual plan under which the planholder is to pay 120 instalments of $20 each, a total of $2,400. The basic sales charge rate of the distribution company is 8.5%, so that total sales charges on the contractual plan are $204. Under the limits proposed above, it could deduct a maximum of $6 (30% of $20) from each of the first thirteen instalments as sales charges, for a total of $78. The maximum deduction for sales charges from the next twelve instalments, at 15% or $3 per instalment, would be $36. After the twenty-fifth instalment, $114 of the total sales charges of $204 would have been received by the distribution company. The remaining $90 in sales charges would be received by the deduction of 94-7/10 cents from each of the remaining 95 instalments. The distribution company could also deduct up to 40 cents (the lesser of $1 or 2% of $20) as service charges from each instalment. At the conclusion of the plan, after deduction of $48 in service charges, and without allowance for change in values of the investment or for dividend payments, the amount invested in shares or units for the account of the planholder would be $2,148.

10.121 As an alternative to the arrangements described above, the contractual plan could be established as a prepaid sales charge plan. From the viewpoint of the purchaser, the plan would be identical except that he would make an initial payment of $78 in addition to the monthly payments. His total payment would therefore be $2,478 instead of $2,400. $6 would be credited to each of the first thirteen instalments increasing the total of each instalment to $26; although 30% of $26 is $7.80, the distribution company would not be permitted to levy sales charges on the amount credited back and would be permitted to retain only $6 as sales charges. The amount invested at the time of each of the first thirteen instalments would therefore be $19.60 after deduction of

sales and service charges. At the end of the period, the total amount invested in shares or units for the account of the planholder would be $2,226 out of $2,478 paid by him rather than $2,148 out of $2,400 paid by him.

10.122 In paragraph 10.117 we propose a refund requirement in the event of early termination of a prepaid sales charge plan. In the example given in the preceding paragraph, if the plan is terminated at the end of the third instalment, the planholder will have paid $78 plus three instalments of $20, for a total of $138. Without allowance for changes in the value of his investment or for dividends, he will hold mutual fund shares or units worth $58.80, after service charges. Upon termination, the distribution company will be required to refund to him the portion of his initial payment not previously credited to subsequent instalments, which would be $60. Again without allowance for fluctuations in value or for dividends, the terminating planholder will therefore receive a total of $118.80, being $58.80 plus $60.

10.123 In paragraph 2.27 we note the periodic payment plan with a redemption fee as a variant of the contractual plan. The regulatory structure should allow flexibility for the development of such plans for the sale of shares or units issued by conventional funds. One restriction is necessary to prevent their abuse. The amount deducted as a redemption fee at the time of termination, plus all sales charges and service charges previously deducted from instalments paid, should not exceed the maximum permissible deduction from those instalments under the restrictions proposed in this section for application to front-end load plans.

10.124 Legislation which implements the proposals made in this section should have no effect on contractual plans outstanding when the relevant requirements become effective. Such legislation should be reconsidered together with the substantive recommendations in the preceding section at the time of the five-year review proposed in that section.

10.125 For the reasons set out in this section, we recommend:

(1) that for purposes of the following recommendations, a contractual plan should be defined as any arrangement for the purchase of mutual fund

shares or units by periodic payments, either by instalments paid on a regular basis over a specified period or by a specified number of instalments, if the amount deducted for sales charges from an initial instalment or a specified number of initial instalments is greater than would be the case if sales charges had been deducted at a constant rate over the life of the plan;

(2) that the sale by contractual plan of shares or units issued by mutual funds categorized as non-conventional under the recommendations in paragraph 12.39 should be prohibited;

(3) that subject to the exception in recommendation (4), at no time during the life of a contractual plan for the purchase of shares or units issued by a conventional fund should the total amount deducted for sales charges exceed the maximum amount permitted to be deducted under the following rules:

(a) total sales charges over the life of the contractual plan may not exceed the basic sales charge rate applied by the distribution company to small lump sum sales of shares or units of the mutual fund concerned;

(b) the maximum deduction for sales charges from each of the first thirteen instalments may not exceed 30% of the amount paid by the purchaser;

(c) the maximum deduction for sales charges from each of the next twelve instalments may not exceed 15% of the amount paid by the purchaser;

(d) the deductions for sales charges from all instalments after the twenty-fifth instalment must be in equal amounts;

(e) where the instalments differ in amount, the rules recommended in clauses (b), (c) and (d) should be appropriately adjusted; the most frequent example is an initial instalment equal to two or more subsequent instalments; and

(f) the percentage deduction for sales charges from any instalment may not exceed the percentage deduction from any prior instalment;

(4) that it should be permissible for the distribution company to receive and to retain an initial payment (referred to in this recommendation as the "prepaid sum") equal in amount to the sales charges deductible from the first and following instalments, not to exceed thirteen in total, provided that the following rules are complied with:

(a) the prepaid sum shall be set up on the books of account of the distribution company as an amount owing to the contractual planholder;

(b) the prepaid sum shall be credited back to the contractual planholder through equal credits to instalments paid by the planholder as they are paid, which additions shall total the amount of the prepaid sum; the number of instalments over which the prepaid sum is credited shall not exceed the number of instalments for which it represents the sales charges;

(c) the portion of the prepaid sum credited to each instalment shall not be subject to sales charges;

(d) if the contractual planholder terminates the plan by transferring his purchased shares or units to a paid-up certificate or by presenting them for redemption before the full amount of the prepaid sum has been credited back pursuant to clause (b), the portion of the prepaid sum not so credited shall be paid to him in cash; and

(e) if at any time before all of the prepaid sum has been credited back pursuant to clause (b) the planholder shall fail to make a payment during a period of six months, the distribution company or other sponsor shall advise him by registered mail of his rights as outlined in clause (d);

(5) that the deductions permitted under the preceding recommendations should be the only deductions from payments under contractual plans, except that it should be permissible to deduct service charges in an equal amount from each instalment, which amount should not exceed a

maximum amount fixed from time to time by regulation and designed to compensate the distribution company for costs of administration; the regulation should initially specify that the deduction for service charges from any instalment may not exceed $1.00 or 2% of the amount of the payment, whichever is less; fees for other administrative services unrelated to the contractual plan and for other items such as completion insurance should not be affected by this recommendation;

(6) that it should be permissible to sell a periodic payment plan for the purchase of shares or units issued by conventional funds, which plan could provide for a redemption fee if the plan was not completed; provided that the redemption fee plus all amounts deducted for sales charges and service charges from instalments paid should not exceed the maximum permissible deduction from instalments paid if the deduction had been effected in accordance with the above recommendations other than recommendation (4);

(7) that the preceding recommendations should have no effect on contractual plans outstanding when the relevant legislation becomes effective; and

(8) that the preceding recommendations should be reconsidered at the time of the review recommended in paragraph 10.93, recommendation (9).

CHAPTER XI

MANAGEMENT AND DISTRIBUTION CONTRACTS

11.01 Sales charges and management fees are the most important aspects of distribution and management contracts from a competitive viewpoint. They are considered in Chapter X. This chapter is devoted to a discussion of other aspects of those contracts which are also of very considerable importance, although less relevant to competition. The fact that the contracts are the source for the entrepreneurial reward of mutual fund organizers is important to most of the proposals made in this chapter, for any regulation concerning the content of the contracts may have some direct or indirect effect on the availability or the amount of that reward. In the formulation of our proposals we have endeavoured to avoid any such effects except where they seemed essential.

11.02 Throughout this chapter as throughout this report the terms "management contract" and "distribution contract" are used to refer to the arrangements whereby the investment management function and the distribution function are carried on by organizations separate from the mutual fund. Only in the case of incorporated mutual funds are these arrangements ordinarily embodied in a document which is, technically, a contract. With mutual funds organized as trusts they form part of the instrument which creates the trust. With a mutual fund organized in another way, the relevant instrument might take some other form. These instruments all produce similar results, and involve similar problems from a substantive viewpoint. For that reason they are considered together in this chapter, with the word "contract" being used to refer

to each of them. It will be necessary for the legislation which implements the recommendations to make appropriate allowance for the differences among the various instruments. The problems this will involve do not raise questions of substance and are not considered here.

11.03 The statement that the various documents which constitute management and distribution contracts involve similar problems from a substantive viewpoint is not meant to imply that their contents are identical. Our study of such contracts shows that there are substantive differences among them, but that those differences are not consequential upon the legal forms of the documents concerned. One exception should be made to this statement: the management contracts of incorporated mutual funds, because of applicable corporate law requirements, invariably purport to reserve to the board of directors of the mutual fund the power to review decisions of the management and distribution companies as they affect the mutual fund. Such provisions are rare with unincorporated mutual funds. Because we do not propose a statutory requirement that all mutual funds must have boards of directors, we attach comparatively little importance to this difference from a regulatory viewpoint. The most significant difference among the contracts is in the allocation of management expenses between the mutual fund and the management and distribution companies. This difference is discussed in the following section.

11.04 In paragraph 6.04 we indicate our acceptance of the philosophy that the mutual fund is used by the management company to sell its investment advice to the public as according with the realities of the situation. The corollary of this is that the investor in a mutual fund should be regarded not as a purchaser of a security in the conventional sense, but as a person who is delegating the management of his invested dollars. This approach is consistent with the sales literature of most distribution companies, which emphasize the quality of investment management provided by the management company. The delegation to another of the right to manage one's invested dollars is a serious decision, and a highly personal one. Yet management and distribution companies, or those who control them, regard their interests in the contracts as a property interest, capable of sale for their benefit.

11.05 Closely related to the concept of the management and distribution contracts as property capable of sale is the fact that the management and distribution companies, or those who control them, are ordinarily in a position to decide the terms of the contracts. At the time of organization of the mutual fund they have complete control of the situation and can embody in the contracts any provision they see fit, provided it complies with the law and is acceptable to administrators with whom prospectuses must be filed. In some cases, particularly with incorporated mutual funds, amendments to the contracts made after public participation in the mutual fund has begun require approval by vote of shareholders or unitholders, but this requirement is comparatively rare and even when it is present the necessary approval is often easily obtained through the use of proxies.

11.06 The situation described in preceding paragraphs has enabled successful management companies, or those who control them, to effect distributions to the public of stock issued by the management company. In such cases, the management company is ordinarily the same company as the distribution company, or the distribution company is a wholly-owned subsidiary company of the management company. Management companies as public companies have been criticized on the basis that their officers are subject to a conflict of interests. It is said that the need to make a profit for their shareholders will reduce the officers' willingness to spend money in performance of their obligation to the mutual fund. It is also said that there are inherent problems involved in the sale to the public of securities issued by a company the principal asset of which is a management contract that is subject to termination.

11.07 The importance of the matters raised in the preceding paragraphs is readily apparent, for the contracts involved are fundamental to the methods of operation of the mutual fund industry. Those matters are discussed in this chapter together with the related question of whether the organizers should be permitted to prepare the management contract so that it calls for payment of a fee which is partially determined by the performance of the mutual fund.

Allocation of Expenses Under Management and Distribution Contracts; Contractual Amendments

11.08 As indicated in paragraph 11.03, the most important substantive difference among the management and distribution contracts entered into with various mutual funds is in the allocation of management expenses between the mutual fund and the management and distribution companies. The disparity of provisions on this point is clearly indicated by Table X-A, set out after paragraph 10.15. In paragraph 10.46 we reject a statutory prescription of the allocation of expenses, and instead propose that the emphasis for purposes of disclosure should be placed on the management expense ratio rather than on management fees. That conclusion is influenced both by the complexity and detail which would be necessary for a complete scheme of expense allocation, and by our belief that no such scheme could adequately allow for the circumstances of individual cases. In this section we return to the question of allocation of expenses in order to determine what, if any, additional provisions are necessary.

11.09 Conclusions set out elsewhere in this report would restrict the extent to which substantive differences among management and distribution contracts on matters other than the allocation of expenses could affect the mutual fund and its shareholders or unitholders. For example, we conclude in paragraph 13.23 that a mutual fund should not be permitted to pay any commission on the sale of its shares or units, and in paragraph 10.80 that it should not pay the costs of judicial proceedings concerning the reasonableness of management fees and sales charges. This section is largely confined to provisions concerning expense allocation, and to procedures on amendments. There are, however, two general conclusions which can conveniently be set out here, each of them designed to provide for complete disclosure of the contracts. We have concluded that all management and distribution contracts should be required to be in writing, and that they should specify in detail all services to be rendered and all compensation to be received, including a clear statement of the manner of computation and payment of the management fee.

11.10 Implementation of the conclusions in the preceding paragraph will require the use of definitions of "management contract" and "distribution contract". The former term should include any arrangement under which the mutual fund is provided with investment advice, alone or together with administrative services, for a fee. The latter term should include any arrangement under which a mutual fund grants the right to purchase its shares or units for resale, or the right to sell its shares or units on its behalf. A single document can be, and frequently is, both a management contract and a distribution contract. For statutory purposes, appropriate adjustments in this definition will be required to allow for the differences among the various types of "contracts". A mutual fund which carried out the management and distribution functions on its own behalf would have no such contracts, and would therefore be unaffected by most of the requirements proposed in this chapter.

11.11 In spite of our conclusion that the allocation of expenses should not be prescribed, we have concluded that those responsible for mutual fund operations should not have completely unfettered authority to force the mutual fund to pay expenses in addition to the management fee. Disclosure of the management expense ratio would not be a sufficient protection against abuse of such a wide authority. The difficulty lies in the determination of appropriate restrictions. These prohibitions referred to in paragraph 11.09 would not alone be sufficient to prevent abuse of the power to allocate expenses, yet a more detailed regulatory scheme would be inconsistent with our general decision not to recommend that the allocation of expenses be prescribed by statute.

11.12 We have concluded that the problem stated in the preceding paragraph can be largely resolved through a requirement that the management and distribution contracts must specify in detail the expenses which the mutual fund may be required to pay in addition to the management fee. The specification should include not only the nature of the expenses but the manner of their allocation among mutual fund, management company and distribution company and among the mutual fund and any other mutual funds under common management. The mutual fund should not be permitted to pay any expenses or costs apart from

management fees and expenses enumerated in the management and distribution contracts, except: income taxes and other charges imposed by government; brokerage and other costs or expenses incidental to the completion of transactions; and custodial expenses. To extend the list of expenses an amendment to the management or distribution contract would be required in accordance with paragraph 11.14.

11.13 It is possible that the allocation of expenses set out in a management or a distribution contract might call on the mutual fund to pay expenses inappropriate for it, such as expenses related exclusively to the sale of shares or units. We have concluded that this possibility can be adequately met through the provision of authority to supplement by regulation the list of expenses which must be borne by the management or the distribution companies. The administrator will be able to exercise this authority in the light of experience and as undesirable practices come to his attention. We would hope that the use of the power would be restricted to exceptional cases, for it is desirable to preserve flexibility in the arrangements adopted by various mutual funds.

11.14 It is apparent from the conclusions set out in this section that we attach considerable importance to the terms of management and distribution contracts. We have concluded that no amendments to them should be permitted without prior consent of shareholders or unitholders obtained in accordance with the provisions enacted pursuant to paragraph 6.57. For this purpose, the renewal of a contract with no other charges would not be considered an amendment; special requirements for renewals are discussed in paragraphs 11.28 to 11.37. The only exception to the requirement for approval of amendments would be cases where the appropriate administrator determined that the proposed amendment was in the best interests of all shareholders or unitholders, or was immaterial to them. In paragraph 12.99 we propose similar restrictions on amendments to statements of investment objectives and practices.

11.15 For the reasons set out in this section, we recommend:

(1) that for purposes of the following recommendations the term "contract" should include a contract entered into with an incorporated mutual

fund, and should also include trust agreements, declarations of trust or other instruments which accomplish similar objectives for mutual funds organized as trusts or in other ways;

(2) that for purposes of the following recommendations the term "management contract" should include a contract, as defined in recommendation (1), under which the mutual fund is provided with investment advice, alone or together with administrative services, for a fee; the term "distribution contract" should include a contract, as defined in recommendation (1), under which the mutual fund grants the right to purchase its shares or units for resale, or the right to sell its shares or units on its behalf and a single contract may be both a management contract and a distribution contract; a mutual fund which performs the management and distribution functions on its own behalf would have no such contracts;

(3) that management contracts and distribution contracts should be in writing and should specify in detail all services to be rendered and all compensation to be received, including a clear statement of the manner of computation and payment of the management fee;

(4) that in addition to the matters referred to in recommendation (3), management and distribution contracts should specify in detail the nature of expenses which the mutual fund may be required to pay in addition to the management fee; such specification should include a clear statement of the manner of allocation of expenses among mutual fund, management company and distribution company, and among the mutual fund and any other mutual funds under common management;

(5) that the mutual fund should be prohibited from paying any expenses or costs other than: those contemplated by the management and distribution contracts, including the management fee; income taxes and other charges imposed by law; brokerage and other costs or expenses incidental to the completion of transactions; and custodial expenses;

(6) that the relevant legislation should include provision for the passage by regulation of prohibitions against the payment by mutual funds of types of expenses specified in the regulation; and

(7) that no amendment should be made to the management or distribution contract without the approval of shareholders or unitholders given in accordance with paragraph 6.59, recommendation (3); provided that a renewal of a contract would not be regarded as an amendment, and further provided that the appropriate administrator should have power to waive the requirement upon being satisfied either:
   (a) that the proposed amendment was in the best interests of all shareholders or unitholders; or
   (b) that the proposed amendment was immaterial to shareholders or unitholders.

Purchases of Management and Distribution Contracts

11.16 The concept of management and distribution contracts as saleable property is ingrained in the mutual fund industry. Persons proposing to enter the industry frequently give serious consideration to whether they should "buy a mutual fund", which means buying the management and distribution contracts for a mutual fund, or should organize their own mutual fund. The purchase of management and distribution contracts can be effected by any of three methods, described in paragraph 11.21. We are aware of five purchases of management and distribution contracts effected by one or other of these methods, which took place in Canada between 1962 and 1967, and it is probable that there were more. The number would probably be higher but for three factors: the success of mutual funds in recent years, which has dissuaded the "owners" of the contracts from their sale; the comparative ease of entry into the mutual fund industry; and the influence of judicial decisions that money paid for the purchase of management or distribution contracts is not deductible or depreciable in the determination of taxable income.*

* Capital Management Limited v M.N.R.
(S.C.C.) 68 D.T.C. 5041 affirming (Ex. Ct.) 67 D.T.C. 5103.

The Investors Group v M.N.R.
(Ex. Ct.) 65 D.T.C. 5120 affirming (T.A.B.) 64 D.T.C. 457.

11.17 The tendency to view the management and distribution contracts as saleable property is a natural result of the fact that they are looked to by the organizers of the mutual fund as the source of their entrepreneurial reward. We recognize that it is desirable to facilitate the receipt of adequate compensation by the successful organizers of a mutual fund. We have, however, concluded that to the extent that restrictions on the saleability of management and distribution contracts seem necessary for reasons of investor protection, we should not hesitate to recommend the imposition of such restrictions. In our view, through the acceptance of money for investment management on the basis of representations as to the quality of management that will be provided, the companies concerned assume at least a moral obligation to purchasers that they will in fact manage that money. The argument that dissenting shareholders or unitholders are adequately protected through availability of the right to redeem is one we reject for the reasons stated in paragraph 6.54.

11.18 The opinion expressed in the preceding paragraph relates logically to the management contract rather than to the distribution contract. For that reason, and because the management contract is of greater concern to an investor once his purchase has been made, the conclusions in this section and many of the conclusions in following sections relate specifically to the management contract rather than to the distribution contract. It is almost inconceivable that either should be purchased without the other, and the conclusions will therefore affect, as a practical matter, purchases of both types of contracts.

11.19 Two other general points should be noted concerning the purchase and sale of management contracts. The first is that such a transaction should not be prohibited, for it may well be in the best interests of the mutual fund. When the management company turns to another line of endeavour, or the proprietor of a one-man management company dies or retires, the mutual fund may suffer unless a sale is arranged. A sale can also be desirable in cases where the management company has not produced satisfactory investment management. In

the next section we recognize the latter point through suggestions designed to deal with cases where mutual fund shareholders or unitholders wish to dispense with an inefficient management company.

11.20 The second general point concerning purchases of management contracts is that they involve a problem of definition. It could be said that there is little or no practical difference so far as the mutual fund shareholder or unitholder is concerned between the results of a change in the identity of the investment manager employed by the management company, and a transfer of the management contract following its purchase. We agree with that statement, but in our opinion it constitutes an argument in favour of the extension of controls to changes of employees rather than an argument against the use of controls. We have concluded that problems of definition and administration would make unworkable any attempt to restrict changes in employees of the management company, but that such problems should not prevent the development of necessary controls over purchases of the management contract.

11.21 Other definitional problems arise from the various ways in which a purchase of the management contract can be implemented. Three separate methods can be defined for analytical purposes. The first is an outright assignment or transfer by the management company of its rights under the contract. The second is the termination of the existing contract, immediately followed by a new contract entered into between the mutual fund and the new management company. The third is the transfer of control of the management company. For reasons indicated in paragraph 11.25, we have concluded that the proposals in this section should apply to the first two types of transfer. The term "transfer of a management contract" as used in the following discussion therefore refers to any transfer effected by either of the first two methods.

11.22 In its Public Policy Report* the Securities and Exchange Commission in the United States expressed concern over a practice found to exist in that country which compounds the problems involved in the transfer of management contracts. Under this practice, the mutual fund pays a portion of the purchase

* Supra, footnote to para. 1.07, pages 149-153.

price through the inclusion in the relevant arrangements of a provision which imposes an obligation on the mutual fund in favour of the transferor; one example, in a case where the transferor is a broker, would be a requirement that all portfolio transactions over a specified period be effected through the transferor. We fully agree with the conclusion reached by the Securities and Exchange Commission that any such provision would be an abuse of the mutual fund and should not be permitted. In our researches we have found no evidence to indicate that similar practices are followed in Canada. We have therefore concluded that legislation to prevent them is not necessary at the present time, but that reliance should instead be placed on the disclosure requirements proposed in the next paragraph. A review should be maintained of the arrangements disclosed so that appropriate steps may be taken if abusive practices should develop in spite of the disclosure requirement.

11.23 We have concluded that no transfer of a mutual fund management contract should be permitted without advance approval of shareholders or unitholders given in accordance with the provisions enacted pursuant to paragraph 6.57. Those provisions would require that complete information be furnished in connection with the solicitation of the approval, and the necessary information should include full disclosure not only of the terms of the transfer but also of any related agreements or arrangements between or among the parties concerned. This would include any arrangements affecting the mutual fund as described in the preceding paragraph; the relevant legislation should specifically require the disclosure of any such arrangement.

11.24 In principle, the conclusions in the preceding paragraph should apply to transfers of the management contract effected in any of the three ways described in paragraph 11.21. They can be readily applied to a transfer or assignment of the contract, and to a cancellation of the contract followed by execution of a new contract. More difficulties arise with their application to a transfer of control of the management company. There are two principal problems in the latter situation. The first is the difficulty inherent in any attempt at a definition of control, which would result in corresponding difficulties in any attempt to require that approval be obtained for a transfer

of control. The second, and the less easily resolved, difficulty is one of principle, namely whether the shareholders or unitholders of the mutual fund should have power to prevent a transfer of control of the management company.

11.25 We think it probable that the first difficulty described in the preceding paragraph could be resolved. This need not be considered in detail, for we have concluded that the second difficulty is sufficiently serious to prevent the application of the approval requirement to transfers effected through the sale of control of the management company. There are many circumstances in which it would be unfair to the controlling shareholders of the management company if the shareholders or unitholders of the mutual fund could prevent the sale of their controlling interest. The most obvious case is the diversified management company, which carries on a variety of activities in addition to mutual fund management; for some of these companies, the management of mutual funds is only a small part of their business. Even in cases where the management company is exclusively concerned with mutual funds, unfair situations can arise. If the management company manages several mutual funds and the shareholders or unitholders of all except one approve the sale, it is hard to maintain that the one disapproval should prevent its completion. Another type of problem situation would be cases where the sale of control is necessary, as for example to raise money for the payment of estate taxes. Not to apply the approval requirement in these cases may make available a loophole in the legislation, but we have concluded on balance that a procedure to plug the loophole would raise more difficulties than it would resolve.

11.26 In paragraph 7.25 we suggest that shares or units having a value of $50,000 should be required to be placed in escrow as a precondition to the registration of a mutual fund. Under the terms of the escrow, transfers of the shares or units would be prohibited without consent of the appropriate administrator. The administrator should withhold his consent to such a transfer until satisfied that any approval required under paragraph 11.23 has been obtained.

11.27 For the reasons set out in this section, we recommend:

(1) that the definitions of "contract", "management contract" and "distribution contract" contained in paragraph 11.15, recommendations (1) and(2) should be applicable to the following recommendations;

(2) that for purposes of the following recommendations the term "transfer of a management contract" should include either of the following:

(a) the transfer or assignment of the rights of the management company under a management contract; or

(b) an arrangement under which a management contract is cancelled and, at or about the time of its cancellation, a new management contract affecting the same mutual fund is entered into with another company;

(3) that no transfer of a management contract should be permitted without the advance approval of the shareholders or unitholders of the mutual fund concerned given in accordance with paragraph 6.59, recommendation (3); the material distributed to shareholders or unitholders to solicit their approval should include complete information concerning related agreements or arrangements, and in particular concerning any obligation on the mutual fund which would arise under the transfer or under the related agreements or arrangements; and

(4) that the appropriate administrator should not consent to the transfer of shares or units held in escrow pursuant to paragraph 7.44, recommendation (2), clause (a) at the time of a transfer of a management contract until he is satisfied that recommendations in this paragraph have been complied with.

Transfers of Management Contracts Required By Shareholders or Unitholders

11.28 The comment in paragraph 11.19 that transfers of management contracts should not be prohibited because they can often be beneficial to the mutual fund leads naturally to the question whether such transfers should occur

only at the instigation of the management company. It is apparent that there are circumstances in which it would be desirable for holders of mutual fund shares or units to have the right to force a transfer. When the management company loses interest in the mutual fund or provides it with poor investment management, the shareholders or unitholders might well wish to force a transfer of the management function to a more efficient company. In addition, the availability of a procedure which would permit such a forced transfer would add a desirable additional competitive element to the mutual fund industry.

11.29 The statements in the preceding paragraph imply a rejection of the belief that the management company should be regarded as entitled to remain in office because it is through the management and distribution contracts that the entrepreneurial reward of the management company and the organizers is earned. The conclusion that procedures should be available for the replacement of the inefficient management company is not inconsistent with recognition of the management contract as a source for entrepreneurial reward. In many other types of public enterprise, management is subject to dismissal by the public shareholders or unitholders. The fact that dismissals are comparatively rare does not mean that procedures for the purpose are unimportant, for they can be used in a serious case. Nor is the availability of the procedures a denial of management's proper reward; it is, rather, a reminder that management has at least impliedly undertaken to operate the organization efficiently and in the best interests of all concerned and that it should not be entitled to a continuing reward if it fails to carry out this undertaking.

11.30 While the advantages of arrangements for the forced transfer of management contracts are apparent, very considerable procedural problems and problems of principle are involved in the development and application of legislation with this objective. In the United States, the Investment Company Act of 1940 requires that the approval of a mutual fund's shareholders or unitholders for its management contract be obtained at least once every two years. One of the purposes of this requirement is to provide them with the opportunity to disapprove the contract. It is clear that this requirement has not in prac-

tice been used for the dismissal of inefficient management companies. The reasons are indicated in the following quotation from a report prepared by the Securities and Exchange Commission:

> The shareholders' opportunity to accept or reject management and shareholder proposals can provide them with meaningful alternatives in connection with most matters for which their approval is solicited. As a practical matter, however, these alternatives do not exist in connection with shareholder approval of advisory contracts. Proxy contests initiated by competing investment advisers have taken place only in very rare instances where existing management relationships have completely broken down. The shareholders themselves cannot select a new adviser, formulate a new advisory contract or set a new advisory fee; only the fund's board of directors and the shareholders acting together can do that. The shareholders alone can only ratify or refuse to ratify what management proposes. Shareholder refusal to adopt or renew the contract proposed by management, however, might leave the fund without an effective advisory contract, and the Act provides that no person or organization may serve as an investment adviser to a registered investment company except pursuant to a written contract. Thus, exercise of the shareholders' right to refuse to ratify the adoption or the renewal of an advisory contract is fraught with uncertainty for — and possibly with harm to — the fund's operations. The drastic consequences that may attend the exercise of that right impair its effectiveness as a control over advisory fees.*

11.31 In spite of the difficulties noted in the preceding paragraph, we have concluded that the procedure followed under the Investment Company Act of 1940 is appropriate for adoption in Canada. This conclusion is reached in part because we have been unable to formulate a superior alternative procedure, and in part because the fact that our responsibilities extend to proposals for legislation to govern the internal proceedings of mutual funds enables us to propose a scheme that should facilitate more effective use of the proposals in Canada than has been true in the United States. We have therefore concluded that no management contract entered into by a mutual fund registered in Canada should bind for a term longer than two years, and that no such contract should be renewed without approval of the holders of shares or units. This would mean that approval would be necessary at least once in every two-year period. The approval would be given in accordance with the provisions enacted pursuant to paragraph 6.57, except that, as proposed in paragraph 11.34, a 66-2/3% adverse vote would be required to withhold approval.

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* Public Policy Report (supra, footnote to paragraph 1.07) page 129.

11.32 If the requirement for regular approval of the management contract is to be of value, provision must be made whereby an alternative can be presented to the holders of shares or units for consideration at the meeting called to vote on the management contract. To accomplish this we have concluded that a shareholder or unitholder in a mutual fund who is dissatisfied with the quality of incumbent management, referred to in the following discussion as the "dissatisfied shareholder or unitholder" should be permitted to approach another management organization to ascertain whether it would be willing to assume the management and distribution functions for the mutual fund. That organization should also be prepared to purchase and put in escrow shares or units of the mutual fund with a value of $50,000 in order to satisfy the proposal in paragraph 7.25, if it is called upon to assume the management and distribution functions. If the organization, referred to in the following discussion as the "nominee management and distribution company" is prepared to assume these responsibilities, the dissatisfied shareholder or unitholder should be entitled to support the nominee management or distribution company at the meeting of shareholders or unitholders.

11.33 It would be important for shareholders or unitholders to be provided with complete information prepared by both sides before a meeting such as is contemplated by the above suggestions. Only thus will the selection between management companies be meaningful. The obvious method to facilitate this would be for the shareholder or unitholder, or the nominee management and distribution company, to be given a list of those entitled to vote so that material could be distributed. We have, however, concluded that it would not be appropriate to require that access be provided for that purpose to lists of shareholders or unitholders although the lists could be released voluntarily. While under most corporations acts a shareholder is given access to shareholders' lists as of right, we agree with the principle of the prohibition contained in several such acts in Canada against the use of the lists to solicit shareholders for the purchase of securities issued by other companies. We are concerned here with the danger that the procedure we propose might be used as

an opportunity to sell shares or units issued by mutual funds associated with the nominee management and distribution company.

11.34 Unless the list of holders of shares or units was released voluntarily, the incumbent management and distribution company or the custodians who have lists of shareholders or unitholders would be required to send material on behalf of the nominee management and distribution company to all those entitled to vote at the meeting, on payment of reasonable costs of mailing. Material sent should include a copy of the management and distribution contracts proposed by the nominee management and distribution company, and a clear statement that it is prepared to assume its obligations immediately after the meeting. A reasonable amount of additional material could also be sent on the same basis. At the meeting of shareholders or unitholders called in accordance with the procedure described above, the management and distribution contracts with the incumbent company would first be submitted to the meeting. They would be deemed to be confirmed unless voted against by the holders of more than 66-2/3% of the shares or units present in person or represented by proxy. We have concluded that this percentage requirement is appropriate in order to avoid the possibility of abuse of the procedures we propose; if the procedures prove ineffective, consideration should be given to a requirement that the present contracts be affirmed by a majority of those voting, as would be necessary for approval of an amendment to the contract other than its renewal. If less than one-third of the votes were cast in favour of the existing contract, the meeting would then consider management and distribution contracts with the incumbent company, together with those submitted by the nominee management and distribution company. The contracts for which the largest number of votes was cast would become effective. If there was more than one nominee management and distribution company, the management and distribution contracts proposed by them should all be considered; a series of votes should be held with one pair of contracts eliminated each time until one pair received an absolute majority of votes cast.

11.35 The procedures outlined in preceding paragraphs do not differ in principle from those followed by most public companies. The existing contracts, like a board of directors, will ordinarily be approved as a matter of routine; a contest will occur only when steps are taken to put an alternative before the meeting. The sole purpose of our proposals is to enable alternative management and distribution companies to be placed before a meeting of shareholders or unitholders. The adequacy of the incumbent management and distribution company can then be determined with a meaningful alternative immediately available.

11.36 As indicated above, if the shareholders or unitholders adopt the contracts submitted by a nominee management and distribution company, those contracts should become effective immediately. The $50,000 held in trust for the successful nominee company should be applied in satisfaction of the escrow requirement proposed in paragraph 7.25 and the shares or units previously held in escrow under that requirement should be released. Regardless of the provisions of the contract or contracts with the incumbent management and distribution company, no penalty should be payable for the termination of the existing contract or contracts. Contractual plans would be unaffected by the change by reason of the proposals made in paragraphs 8.52 to 8.63.

11.37 While the proposed procedure is designed to be self-enforcing, it is unlikely that the dissatisfied shareholder or unitholder and the incumbent organization will be fully co-operative in its application. It will, therefore, be necessary for the appropriate administrator to maintain a continuing review of the developments in order to ensure that all concerned comply with the statutory scheme in the best interests of shareholders or unitholders.

11.38 For the reasons set out in this section, we recommend:

(1) that the definitions of "contract", "management contract" and "distribution contract" contained in paragraph 11.15, recommendations (1) and (2) should be applicable to the following recommendations;

(2) that no mutual fund should be permitted to enter into a management contract which binds it for a period in excess of two years, and that renewal of a management contract should not be permitted without the approval of shareholders or unitholders given in accordance with paragraph 6.59, recommendation (3), subject to the special requirements concerning voting set out in recommendation (6);

(3) that a mutual fund shareholder or unitholder (hereinafter referred to as the "dissatisfied shareholder or unitholder") who is dissatisfied with the management and distribution companies (hereinafter referred to as the "incumbent management and distribution company") of the mutual fund should be permitted to approach another organization (hereinafter referred to as the "nominee management and distribution company") to ascertain whether it would be prepared to assume the management and distribution functions for the mutual fund;

(4) that if the nominee management and distribution company is prepared to assume the management and distribution functions, and to comply with the escrow requirement proposed in paragraph 7.44, recommendation (2), clause (a), the dissatisfied shareholder or unitholder should be permitted to nominate it to replace the incumbent management and distribution company;

(5) that during the period prior to the meeting held pursuant to recommendation (2), the incumbent management and distribution company (and any custodian who holds the relevant lists) should, on payment of reasonable fees and expenses, send to the shareholders or unitholders entitled to vote at such meeting, material prepared by any dissatisfied shareholder or nominee management and distribution company which material should in all cases include management and distribution contracts which the nominee management and distribution company is prepared to enter into with the mutual fund and a clear statement that the nominee management and distribution company is prepared to assume its obligations immediately;

(6) that at the meeting of shareholders or unitholders called pursuant to recommendation (2) the management and distribution contracts with the incumbent management and distribution company should first be submitted to the meeting; they would be deemed to be confirmed unless rejected by the votes of over 66-2/3% of the shares or units present in person or represented by proxy at the meeting; this percentage requirement should be kept under continuing review and increased to a requirement for approval by majority vote if the relevant provisions prove ineffective to accomplish their objective;

(7) that in the event that the management and distribution contracts with the incumbent management and distribution company were not confirmed pursuant to recommendation (6), such contracts and the contracts proposed by any nominee management and distribution company should be submitted to the meeting; if there is more than one nominee management and distribution company, the contracts receiving the smallest number of votes should be eliminated and further votes taken until one pair of management and distribution contracts was approved by an absolute majority of shares or units voted;

(8) that the management and distribution contracts approved pursuant to recommendation (7) should become immediately effective; if they are the contracts submitted by a nominee management and distribution company, no damages or penalty should be payable to the incumbent management and distribution company;

(9) that if the management and distribution contracts approved pursuant to recommendation (7) are those submitted by a nominee management and distribution company, any shares or units currently in escrow pursuant to the escrow requirement proposed in paragraph 7.44, recommendation (2), clause (a) should be released to their beneficial owners, and the nominee management and distribution company should be required to comply with the escrow requirement; and

(10) that the appropriate administrator should maintain a continuing review of each case in which a dissatisfied shareholder or unitholder makes use of the procedure contemplated by the preceding recommendations in order to ensure that the statutory scheme is adhered to by all concerned in the best interests of shareholders or unitholders.

Incentive Management Fees

11.39 In paragraph 10.47 we note that the practice followed in the mutual fund industry for the computation of management fees is relatively uniform, in that almost every Canadian mutual fund pays a management fee computed as a percentage of average total net assets. We therefore conclude that this method of computation should be required in all cases, a conclusion based on the need for comparability of management fees and management expense ratios among mutual funds. Another reason for this conclusion is that most other methods of computation would involve the investment managers in a conflict of interests. For example, management fees computed as percentages of realized capital gains or income receipts might tempt the managers to place undue emphasis on transactions that would result in capital or in income. Similar problems would arise with other types of management fees.

11.40 The requirement that management fees be computed as a percentage of average total net assets leaves open the question of how the relevant percentage is to be determined. The method most widely used is a fixed percentage schedule, sometimes declining as total net assets increase in a manner similar to that contemplated by the Ontario Securities Commission policy ruling quoted in paragraph 10.16. However, with approximately six Canadian mutual funds the percentage is in part determined by a comparison between the performance (usually used in the sense of rate of return) of the mutual fund and that of an indicator such as a published market index. A typical statement of a management fee determined in this way might read: "The compensation to be paid the investment manager will be 3/4 of 1 per cent of average total net assets per annum. This figure will be increased by 1/8 of 1% for each five percentage points by which the performance of the mutual fund exceeds that of the

T.S.E. Industrial Index." More wide-spread adoption of this type of management fees by mutual funds has been resisted by securities administrators for reasons indicated in the following discussion. In this discussion, we refer to management fees determined as a percentage of average total net assets as "incentive management fees" in cases where the percentage is partially or entirely determined by comparison of performance with that of an indicator, and as "fixed percentage management fees" in cases where the percentage is determined by a fixed schedule.

11.41 It is important to appreciate that incentive management fees are not alone in being affected by the performance of the mutual fund. That is also true of fixed percentage management fees. One type of relationship between fixed percentage management fees and performance lies in the fact that good performance is usually associated with a high rate of return, and a high rate of return increases total net assets with a consequent increase in management fees even when they are determined by a fixed schedule. A less direct, but perhaps more important, relationship is that good performance ordinarily results in a higher volume of sales, thereby increasing total net assets and with it the management fee. Incentive management fees merely accentuate the closeness of the relationship between performance and management fees. The argument of those who feel that incentive management fees are appropriate is stated as follows in one submission to us:

> Most mutual funds are paid a straight percentage of the assets under administration (usually ½ of 1% per annum) for investment advice and other management services. A portion of this fee represents the management company's reward for its entrepreneurial success. Insofar as the portion of the fee for investment advice is concerned, however, there is no relationship between the size of the fee and the value of the advice.
>
> In our judgement, payment for a service such as investment advice should be on the basis of the value of the service not on the cost of its production. Such a concept is similar to the payment for a piece of art work which has no relationship to the cost of the ingredients or to the payment by a company to an employee for a money saving idea, which has no relationship to the amount of time that he spent thinking of the idea. To the investor, it is the results that count. The cost of providing the investment management services is immaterial.*

* Phillips, Hager and North Ltd., Submission to the Canadian Committee on Mutual Funds and Investment Contracts (Vancouver, 1968) p. 1.

So stated, the argument is a strong one. It is natural that both those who supply a service and those to whom the service is supplied should wish the compensation to be affected by the quality of the results produced. Such arrangements are common in the business world, and on initial impression it might seem that they should be appropriate in the context of mutual funds.

11.42 Many arguments are advanced against the use of incentive management fees, or of other types of fees based on performance. They range from the contention that such fees are bad in principle to the contention that they are acceptable in principle but that the necessity for regular computation of net asset value prevents their use on any fair basis by a mutual fund. Other arguments adopt positions between these two. In the following discussion we consider first the more general arguments of principle, and then the technical questions involved in the computation and payment of incentive management fees.

11.43 There are three basic and closely related arguments of principle which are advanced against the use of incentive management fees. The first, which goes to the root of the arguments advanced in the quotation in paragraph 11.41, is that investment management is a professional responsibility. The manager undertakes to use his best efforts to manage money on a basis consistent with the investment objectives of those who entrust it to his care, and the quality of his management should not be affected by the basis of his reward. The second is that incentive management fees may encourage the investment manager to take unnecessary risks with the mutual fund portfolio. If the risks are successful, he will earn a higher management fee; if they are unsuccessful, the shareholders or unitholders will suffer the resultant loss. In other words, the contention is that the investment manager is able to take unnecessary risks with other people's money. Inclusion in an incentive management fee arrangement of provision for a penalty against the management company in the event of poor performance as well as a bonus for good performance constitutes a partial, but not a complete answer to this argument. The third argument arises from the difficulty in determination of the quality of performance. We comment in Chapter III on the problems inherent in an assessment of the quality of performance of a mutual fund, and criticize the tendency to rely on rate of return as the

exclusive determinant; we are particularly critical of reliance on rates of return established over a short period of time. Yet in the computation of an incentive management fee it is necessary to measure performance with complete precision according to a pre-determined formula. This necessity has resulted in reliance on rate of return as the exclusive determinant of performance for incentive management fees in spite of the problems involved, since no other method of expressing performance in precise mathematical terms has found wide acceptance.

11.44 The three arguments of principle summarized in preceding paragraphs indicate clearly that the use of incentive management fees is inappropriate for mutual funds with investment objectives that do not contemplate the acceptance of risks in the pursuit of maximum rate of return. It is of interest that each of the Canadian mutual funds which presently pay incentive management fees has such investment objectives. In paragraphs 12.30 to 12.39 we propose the adoption of two categories of mutual funds, conventional and non-conventional. Mutual funds categorized as non-conventional would be permitted greater flexibility to engage in investment activities which are associated with risk-taking, such as short selling and borrowing for leverage. We think that most or all mutual funds with investment objectives that contemplate the acceptance of risks in the pursuit of maximum rate of return would wish to be categorized as non-conventional, and we are clearly of the opinion that conventional funds should not be permitted to pay incentive management fees.

11.45 To say that incentive management fees should be prohibited for conventional funds is not intended to imply that they should be permitted for non-conventional funds. That question has caused us considerable concern. The argument that investment management is a professional task, while relevant, would not alone persuade us that incentive management fees should be prohibited for non-conventional funds. Nor would the argument that incentive management fees encourage undue risk-taking lead us to that conclusion. The argument that rate of return is not an acceptable criterion for performance, even for mutual funds with investment objectives that contemplate the acceptance of risk, is considerably stronger. As the discussion in Chapter III indicates, it may be

misleading to assess the performance even of high-risk mutual funds solely on the basis of their rate of return. The dangers are particularly acute when, as would almost inevitably be the case in the determination of incentive management fees, the rate of return analysis is made for a comparatively short period. For this and other reasons indicated in the following paragraphs, we have concluded that incentive management fees should be prohibited for non-conventional as well as for conventional funds.

11.46 The selection of an indicator with which to compare the rate of return of the mutual fund adds further difficulty to the incentive management fee structure. The comparison should be with an indicator that is relevant to the investment objectives of the mutual fund. Doubts have been expressed to us as to whether a growth-oriented mutual fund should be compared with the Dow-Jones Industrial Average, since that indicator is largely made up of senior securities in which many of the aggressive new mutual funds are uninterested. While we do not comment on the merits of the example, it does illustrate the conclusion that the comparison should be with a relevant indicator. For this purpose, "indicator" is used in a wide sense; one Canadian mutual fund pays an incentive management fee computed by comparison of its rate of return with the average attained by the ten largest Canadian mutual funds. Regardless of the nature of the indicator used, it will be difficult or impossible to find one which is relevant to the investment objectives of the mutual fund.

11.47 Even if an indicator is found which is comparable to the mutual fund on the basis of investment objectives, to make it fully comparable on the basis of investment practices would probably be impossible. The mutual fund, as a non-conventional fund, would usually have the power to borrow or to effect short sales of securities, powers which would be difficult or impossible to reflect in an indicator. In addition, the indicator might relate to a single securities market, while the mutual fund could invest anywhere in the world. We do not think a management company should be paid extra compensation for the production of a rate of return superior to that of an indicator which does not reflect the availability of such trading advantages.

11.48 Even if a fully comparable indicator is available, there are serious difficulties in the procedures whereby rate of return of the mutual fund is compared with that of the indicator to determine the management fee. As the statement of a typical incentive management fee in paragraph 11.40 exemplifies, the usual arrangement is that if the rate of return of the mutual fund exceeds that of the indicator by a specified amount, the percentage of average total net assets paid by way of management fee is increased. The difficulties lie in the application of this arrangement, given the necessity to compute net asset value of the mutual fund at regular intervals.

11.49 Fixed percentage management fees are fully consistent with the need for regular determination of net asset value. A deduction is made from each net asset value determination to reflect the amount of the management fees earned since the preceding valuation. Properly carried out with a fixed percentage management fee, this procedure leads to an exact result, so that no annual adjustment is necessary. That is not true with most incentive management fee arrangements; the fee is usually either computed and paid at the year-end, or estimated on valuation dates during the year subject to a year-end adjustment. It is readily apparent that an arrangement under which the management fee for the year is computed and paid at the year-end is undesirable; shareholders or unitholders who, for example, redeem the day before the determination, do not absorb any management fees, and the price for shares and redemptions throughout the year does not properly reflect management fees. The problem may be only slightly alleviated if an imprecise estimate is made at each valuation date, subject to a year-end adjustment when the exact fee for the year can be computed.

11.50 The points stated in the preceding paragraph would seem to dictate that incentive management fees should be reflected in net asset value computation in the same manner as are fixed percentage management fees. This would require a comparison between the indicator and the mutual fund at the time of each net asset value computation in order that the management fee allocable to the period since the last such computation could be accurately determined. Such a procedure might, however, be inconsistent with the fact,

noted in Chapter III, that use of rate of return information to contribute to an assessment of the quality of investment management of a mutual fund may be misleading unless at least five years' history is used. Rate of return over a shorter period is too likely to be affected by random factors. Thus, on the one hand it is desirable to effect the comparison on a daily basis; on the other hand, it is desirable to effect it only when five years' data are available.

11.51 As if the problems referred to in the preceding paragraphs were not enough, there is another difficulty which we think should be recognized in the formulation of an incentive management fee structure. Most of the incentive management fee arrangements presently in effect involve the use of a comparison of the relative performance of the mutual fund and the indicator over a prior period to determine the percentage management fee over a subsequent period. This involves two problems. The first problem is that the mutual fund may be called on to pay management fees at a higher rate during the second period because of a rate of return which exceeds that of the indicator in the first period, although the rate of return in the second period does not exceed that of the indicator. This would result in inequitable treatment of every shareholder or unitholder with the possible exception of one who held throughout the two periods. Those who hold only during the first period may absorb a management fee lower than justified by their rate of return, and those who hold only during the second period will absorb a management fee higher than justified by their rate of return.

11.52 The second problem with the use of past performance to determine future compensation is that, if the assets of the mutual fund increase considerably, the reward may be paid on the basis of a larger total net asset value than that managed when it was earned. For example, at the beginning of the first year of a two-year period the mutual fund may have total net assets of $1,000,000. During that year its rate of return may substantially exceed that of the indicator used for comparison, and its total net assets at the end of the year may be $5,000,000. In the second year sales of shares or units may

continue at a high rate because of the reputation earned in the first year, so that the average total net assets in the second year are $20,000,000 although the rate of return during that year does not exceed that of the indicator. If the management fee during the second year is calculated with an increased percentage rate determined by the rate of return in the first year, the result would be unduly large compensation for the management company, as well as being unfair to shareholders or unitholders who purchase during the second year.

11.53 The problems noted in the two preceding paragraphs can have important consequences, for assets of a mutual fund may increase rapidly during a period of high rate of return, both because of accretions in value of portfolio securities and because of increased sales of shares or units. It is generally assumed within the mutual fund industry, although we have no statistical proof of the assumption, that it is easier to produce a high rate of return when the total assets involved are comparatively small. If that assumption is correct, an incentive management fee structure under which the percentage reward in one period is determined by rate of return in a preceding period would frequently have the adverse effects described in the two preceding paragraphs.

11.54 Numerous attempts have been made, particularly in the United States, to arrive at procedures which will adequately resolve the problems discussed in preceding paragraphs. We do not here propose to review the various procedures, for they differ considerably and adequate explanation would require the inclusion of considerable detail. Our staff and consultants have analyzed many of the various procedures presently in use by mutual funds qualified for public sale in Canada or the United States, and have made use of computer facilities to test several procedures against the actual price record of a mutual fund and corresponding changes in an index. Our conclusion on the basis of these analyses and tests is that none of the procedures tested provides precision of calculation without adjustments at the end of a period and yet avoids the problems inherent in the determination of compensation during a period by the rate of return attained in a prior period. Nor have we been able to devise an alternative arrangement which would adequately resolve the problems.

11.55 We are fortified in our conclusion against incentive management fees by our belief that the inability to pay such fees will be adequately compensated by the additional recommendations made in Chapter X . The greater flexibility in the percentage rates fixed for management fees which would result from implementation of those recommendations should remove much of the pressure from the mutual fund industry for incentive management fees. This is particularly true in view of the fact that the quality of investment management is one of the factors to be considered in the assessment of the reasonableness of management fees. We are also fortified in our conclusion by the closeness of the relationship which exists between the usual type of management fee and the rate of return attained by the mutual fund, as described in paragraph 11.41.

11.56 For the reasons set out in this section, we recommend:

> that management fees paid by mutual funds should be required to be calculated as fixed percentages of average total net assets, in accordance with paragraph 10.48, recommendation (4), and that the percentages should not be affected by performance of the mutual fund.

CHAPTER XII

INVESTMENT PRACTICES

12.01 Since mutual funds exist to facilitate the delegation of money management, any restrictions on the uses to which the money may be put by those to whom management is delegated are of obvious importance. Their importance is accentuated by the weight given by many mutual fund investors to comparative investment performance, usually measured by them in terms of rate of return. No matter how carefully formulated an investment restriction may be, it is obvious that sometimes, and in some circumstances, the necessity of adherence to it may have an adverse effect on rate of return.

12.02 Throughout this chapter, investment objectives should be distinguished from investment practices. The former sets out the goals being sought in the management of the portfolio; perhaps the most important item of information conveyed by a well-drawn set of investment objectives is the degree of risk which will be accepted in the quest for a higher rate of return. Investment practices are the techniques available to assist in the attainment of the investment objectives. Every mutual fund prospectus includes a statement of investment objectives and practices. By their nature, the investment objectives are stated with less precision than the investment practices; yet, paradoxically, the potential purchaser can usually glean more information from the former than from the latter. This paradox is largely the result of the existing regulatory structure.

12.03 In paragraph 3.10 we provide two examples of statements of investment objectives which illustrate both the vagueness of these statements and the fact that helpful information can be gained from the comparison of the investment objectives of different mutual funds, in spite of their vagueness. This is because the statements of investment objectives differ appreciably between mutual funds, particularly in cases where a management company is associated with a number of mutual funds which are designed to appeal to different classes of investors. In paragraph 3.24 we note the finding made by Professors Bower and Williamson that a ranking of mutual funds by risk on the basis of a study of the published statements of investment objectives would enable the investor to place a particular mutual fund reasonably well on the spectrum of risk as determined by historical variability or volatility.

12.04 Statements of investment objectives have not been a focus of attention on the part of administrators. No objection is advanced by them to such statements regardless of where on the spectrum of risk they place the mutual fund concerned. This is not true of statements of investment practices, which are capable of more precise delineation and of adequate enforcement. It is difficult to prove whether a statement of investment objectives which says that a high degree of risk will, or will not, be accepted in the quest for rate of return has been contravened; it is easy to prove whether a statement of investment practices which says that no short sales will be effected has been contravened. For these reasons, regulatory attention has tended to focus on the statement of investment practices rather than on the statement of investment objectives.

12.05 The attention paid to the statement of investment practices is not only understandable but also, we have concluded, unavoidable. The difficulty is that no attempt has been made to link investment practices with investment objectives. Similar restrictions on investment practices are imposed by administrators on all mutual funds. Regardless of their investment objectives, portfolio managers are anxious to be subject to as few limitations as possible on investment practices. As a result, virtually all mutual funds, regardless of their investment objectives, have statements of investment practices which are

as liberal as the administrators will permit. This is the reason why the latter statements do not differ significantly among most mutual funds, and it also accounts for the paradox noted above: the differences among the vague statements of investment objectives are more meaningful than those among the precise statements of investment practices. It is also important that the former indicate what the mutual fund will do; the latter only indicate certain things that it will not do.

12.06 While in this chapter we accept that the principal focus of regulation in this area must be on practices rather than objectives, we make proposals designed to resolve the paradox discussed above. Such proposals are based on the distinction, crucial to the scheme we propose, between conventional and non-conventional funds. In this chapter we first consider definitions, and then discuss the distinction between conventional and non-conventional funds together with the questions of principle which underly many of the existing restrictions on investment practices. Subsequent sections consider the precise restrictions which should apply to conventional and to non-conventional funds.

Definitions

12.07 The following sections of this chapter make use of a number of terms which are in common usage within the mutual fund industry. In spite of their common usage, many of them lack exact meanings. Others may be unfamiliar to some readers of this report. For these reasons, and because of their importance to the conclusions reached in this chapter, a number of the more important terms are defined in this section. Definitions of others are supplied where relevant in the chapter. Except for those terms as to which exact meanings are generally accepted, the definitions represent our conclusions concerning the meaning the terms should have in the regulatory scheme we propose; they do not purport to reflect a general consensus on the meanings of the terms.

12.08 The techniques with which we are concerned can be divided for analytical purposes between types of transaction and types of investment, in the sense of the nature of the assets in which the investment is made. It is

apparent that these overlap: a transaction ordinarily involves an investment. Yet the division is an important one, for in the following sections we discuss types of transaction such as short selling and borrowing as well as types of investment such as illiquid investments and letter stock. In the following paragraphs we consider first the definitions of various types of transaction, and then the definitions of various types of investment. The definitions are general in nature to provide an adequate basis for discussion in subsequent sections. No implication is intended that the types of transaction and the types of investment described are or are not appropriate for mutual funds. That is considered in the later discussion.

12.09 Short sales of investments, particularly of securities, are a controversial type of transaction. Such a transaction is effected by a trader who believes the price of the security will decline, and does not himself own securities of that class. He effects the sale and borrows the securities to deliver to his purchaser. The transaction is usually arranged by a broker, who receives the proceeds of sale to hold as collateral to ensure that the loan of securities can be covered. If the price of the securities subsequently rises, the short seller must provide the broker with additional money as further collateral. Ultimately the short sale is covered through the purchase by the short seller of securities to satisfy the outstanding loan. If that covering purchase is effected at a price higher than the short sale, the short seller suffers a loss; if at a lower price, he receives a profit. An important point is that there is in theory no limit to the potential loss of a short seller, since he must cover the loan regardless of price; his profit, on the other hand, cannot be greater than the proceeds of the original sale even if the price of the security declines to zero. The reverse is true in the case of an ordinary investment where a security is purchased in the hope that its price will rise.

12.10 A short sale involves the assumption of a liability; the same is true of borrowing money for leverage, although the transactions are effected for different reasons. The former involves borrowing securities (or other investments); the latter involves borrowing money. Borrowing money for leverage is an activity of traders who believe they can earn a higher rate of return on

the money borrowed than the interest they must pay on that money. It is apparent that if a security is expected to rise from $10 per share to $20 per share within a year, and money can be borrowed at an interest rate of 10% per year, an investor will make a far higher rate of return on his available capital if he borrows money for investment in the security as well as investing his own capital; correspondingly, he will thereby increase his loss if the price of the security falls. Leverage is an accepted and important part of business activities in many other areas than the securities markets, but its importance in those markets cannot be overestimated.

12.11 While it is not technically a trading activity, reference should be made here to <u>borrowing money to effect redemptions</u>. A mutual fund may sometimes be unable to meet demands for redemption of its shares or units except through the hasty and disadvantageous liquidation of investments. In such circumstances, it may be preferable to borrow money to satisfy the redemptions, in order that the sale of investments can be effected on a more orderly basis. This type of borrowing is very different from borrowing money for leverage.

12.12 Another activity designed to produce leverage is <u>writing puts and calls</u>. We distinguish between this and purchasing puts and calls written by others, which is discussed below as a type of investment. Puts and calls are, respectively, options to sell and options to buy a specified security at a fixed price for a period of time. A trader who believes that a security will increase in price may, instead of purchasing that security, sell a put at the current price; if his prediction is correct, that put will not be exercised for nobody will wish to sell the security to him at that price after the increase occurs. Similarly, a trader who believes a security will fall in price may sell a call instead of effecting a short sale. In each case, the proceeds of sale of the put or call will be a profit received by the trader with no cash outlay; in each case the trader is exposed to a very considerable risk of loss if his prediction is incorrect. That is why the issuance of, or writing, puts and calls is a highly leveraged type of transaction.

12.13 Puts and calls are only one example of the assumption of contractual obligations as a trading activity. Another good example is commidity futures. These are binding agreements to purchase a certain amount of a commodity during a specified future month at an agreed price. They differ from puts and calls in that each party is under a binding legal obligation, the one to buy and the other to sell. Commidity futures are so easily dealt in and liability under them is so readily terminated by an offsetting transaction that the legal liability of the holder is often overlooked. Both puts and calls and commodities futures differ from other obligations assumed in the course of trading in that they are not, in law, capable of immediate discharge. They can be avoided through offsetting transactions, but contracts themselves impose an obligation for a fixed period of time. In the following sections, we use the phrase "fixed-term financial commitments" to refer to puts and calls (as they affect the trader who writes or issues them), commodity futures, and any other contractual obligation under which the trader assumes a legal liability which is not, by the terms of the contract, capable of liquidation until a future date.

12.14 The definitions set out in preceding paragraphs are relevant to trading by any participant in the securities markets; any analysis of trading would probably include similar definitions. The second of the two divisions referred to in paragraph 12.08, types of investment, involves questions that are of considerably greater importance with mutual funds than with other traders. The necessity to accept shares or units for redemption on demand by their holders, without any control over the flow of redemptions and even without the ability to make a precise prediction of when a large volume of redemptions will occur, is a serious responsibility. The corresponding obligation to effect regular valuations of assets in order to compute net asset value per share or unit is also a serious responsibility. In later sections of this chapter we conclude that the assumption of these responsibilities should be considered to result in certain continuing obligations, to restrict the extent of investment in assets which would reduce mutual fund liquidity or would make precise valuations more difficult. In the following discussion we define three terms which are relevant to those obligations: "liquid investments"; "illiquid investments"; and "assets inappropriate for mutual fund investment".

12.15 We have concluded that the various categories of investment should be defined in a manner such that all assets will fall within one category or another. To carry out this conclusion, illiquid investments should include all assets and investments other than those which are considered to be either liquid investments or assets inappropriate for mutual fund investment. The lines between liquid and illiquid investments, and between the latter and assets inappropriate for mutual fund investment, are not luminescent, which is not surprising given the nature of the problems the definitions are intended to resolve. We have therefore concluded that the appropriate administrator should have an overriding authority to determine into which of the three categories a particular asset or class of assets falls. In making that determination the administrator should not be fettered by the definitions, except that their constituent elements should constitute guidelines to him in the exercise of his discretion.

12.16 Liquid investments should be those which can be valued with relative precision and can be disposed of without undue difficulty. It is obvious that the two requirements are closely related: almost any asset can be disposed of if the seller is heedless of price, but if that is to be the basis of sale the asset cannot be properly valued before it is sold. In Chapter XIII we comment on problems of valuation, and observe that the objective in valuation of a mutual fund portfolio is not to arrive at liquidation value or at a price for which the portfolio could be duplicated. Rather, the mutual fund must be valued on a basis which treats it as a continuing operation. That is also of great importance in arriving at the definition of liquid investments; they need not be restricted to those which can be expeditiously disposed of at an established price.

12.17 We have concluded that a particular asset should be regarded as a liquid investment if it satisfies one or more of three tests and if the mutual fund concerned is in a position to sell its holdings of the investment without restraint. The latter condition is commented on below. The first test is that any investment of a class listed and posted for trading on a stock exchange or traded regularly in a public trading market should be a liquid in-

vestment if price quotations for it based on such trading are regularly published. We recognize that this test will result in the inclusion as liquid investments of many securities the liquidity of which is questionable. Particularly on the Canadian stock exchanges there are many securities listed which in fact trade comparatively infrequently; a substantial block of such securities might be very difficult to sell at or near quoted prices. We have, however, been unable to devise any narrower test which would not unduly limit the category of liquid investments.

12.18 The second test we propose that would establish an asset to be a liquid investment is the availability of facilities that will readily permit its disposal for an amount substantially equal to the price at which it is valued in the determination of net asset value. Such facilities might arise from the terms of the instrument, or from the existence of a reliable market. The best examples of the former are shares or units of other mutual funds, because of the right to redeem, and debt instruments payable on demand. The best examples of the latter are bonds, which can usually be disposed of at a price that is substantially equal to their appropriate valuation. For reasons discussed in paragraph 12.47, an investment should not be considered to satisfy this test merely because a company associated with the mutual fund has agreed to purchase the investment if liquidity problems arise.

12.19 The third, and most obvious, of the tests which would establish an asset as a liquid investment is that cash and its equivalent should be so treated. This should include cash of any country provided conversion into Canadian currency may be readily effected, and should also include gold (while its price is supported by government) and similar investments generally regarded as the equivalent of cash. Gold might also be a liquid investment under the first test, if a public market existed in which it was freely traded and which provided regularly published price quotations.

12.20 Assets inappropriate for mutual fund investment should include those types of assets which do not properly belong in an investment portfolio, either because they require a more active involvement than is consistent

with an investment or because they cannot be sold and therefore cannot effectively be used to realize a profit. Included in such assets would be those that satisfied either of two tests. The first test would include any asset that, subsequent to its purchase and while it remained part of the assets of the mutual fund, required payment of costs or carrying charges of kinds not customary in the maintenance of an investment portfolio. Real estate would, under this test, be treated as an asset inappropriate for mutual fund investment because of taxes and the cost of upkeep. The same would be true of many or most physical assets: a mutual fund ought not to purchase a steamship or even a part interest in a steamship, although it should be able to acquire shares in a company that operates a steamship line.

12.21 A restriction on the scope of the test proposed in the preceding paragraph is that an investment ought not to be regarded as an asset inappropriate for mutual fund investment simply because costs are involved at the time of its liquidation or other realization. Such costs are not carrying charges, and are not inconsistent with the treatment of an asset as an investment. For example, a mortgage ought not to be considered as an asset inappropriate for mutual fund investment because legal fees must or may have to be paid when it matures.

12.22 In paragraph 12.17, we propose that an investment which is subject to a restraint on sale by the mutual fund should not be treated as a liquid investment. The second test we propose to identify assets inappropriate for mutual fund investment relates to some assets of this type. If the restraint on disposition of an investment is such that the consent of a third party (other than a governmental agency) is required for its effective sale, that investment should be considered an asset inappropriate for mutual fund investment. An important example is shares of a private company the board of directors of which must consent to their transfer. Another is securities sold in private placements where the purchaser undertakes not to resell without consent of the vendor. However, an asset would not be considered inappropriate for

mutual fund investment if its sale was prohibited until some other legal condition was satisfied, such as the consent of a regulatory agency or the expiry of a specified period of time.

12.23 The definitions proposed in preceding paragraphs can be exemplified by considering their application to certain types of investment. In paragraph 12.21, we note that mortgages do not satisfy the first test of assets inappropriate for mutual fund investment. They do not satisfy the second test either, and must therefore be either liquid investments or illiquid investments. Of the three tests of liquid investments, it is clear that mortgages satisfy neither the second nor the third. They would satisfy the first test only if a public trading market developed in them, with regularly published price quotations. No such market has developed to the time of writing. Mortgages, being neither liquid investments nor assets inappropriate for mutual fund investment, must therefore be illiquid investments.

12.24 In paragraph 12.12 we define "writing puts and calls" and briefly describe what puts and calls are. While writing puts and calls is not an investment activity, for it involves the assumption of a liability rather than the acquisition of an asset, purchasing puts or calls written by others is an investment activity. No liability is involved; the purchaser has the right to exercise an option to sell or to buy, and can permit that option to expire if thought fit. The purchase of puts or calls written by others is, then, not the same as the assumption of a fixed-term financial commitment as defined in paragraph 12.13. Puts and calls written by others do not fall within either of the tests of assets inappropriate for mutual fund investment. Like mortgages, they should be regarded as illiquid investments unless they have a public trading market with regularly published price quotations. Such a market has developed in the United States with puts and calls of many securities, but to the time of writing no such market has developed in Canada.

12.25 Commodity futures present problems different from puts and calls written by others. A commodity future is not an option; it is a binding agreement of purchase and sale which subjects both parties to a fixed-

term financial commitment unless they can avoid the commitment through an offsetting transaction. In paragraph 12.42 we propose that mutual funds should be prohibited from fixed-term financial commitments; even apart from that conclusion, we would regard commodity futures as inappropriate for them because they are contracts for the purchase of an asset which would be an asset inappropriate for mutual fund investment. We acknowledge that this is a conservative approach to commodity futures, which are a well-established part of the securities markets. The comments in paragraph 12.38 are relevant here; if our proposal for the creation of non-conventional funds proves successful during an experimental period, the administrators concerned should reconsider whether non-conventional funds ought to be permitted to trade in commodity futures.

12.26 Securities purchased in private placements involve particular difficulty both because the terms of purchase differ considerably and because the relevant law is not clear in Canada. The legal problems are discussed in paragraphs 13.35 to 13.38, where we conclude that the significance of the "investment intention" requirement which is a condition of most or all private placements has not, to the time of writing, been clarified in Canada. That requirement is reflected in many private placements by a requirement that the purchaser deliver to the vendor a letter attesting to the requisite intention. Similar letters used in the United States have resulted in the use of the term "letter stock" to describe securities subject to a restriction on disposition resulting from a representation of investment intention given at the time of acquisition.

12.27 Some letters given by purchasers of letter stock indicate that they will not sell the stock without prior consent from the vendor. We comment in paragraph 12.22 that securities as to which such a representation is given should be treated as assets inappropriate for mutual fund investment. Most letters simply state that the purchaser has an investment intention, or state that the purchaser will not sell the securities without the consent of a stock exchange or securities administrator. In the latter two cases the securities would not be assets inappropriate for mutual fund investment, nor would they be liquid investments. They would therefore be illiquid investments.

12.28 While the definitions of the various types of assets contained in this section will, we believe, provide a workable set of guidelines, the discretionary authority of the administrator proposed in paragraph 12.15 will be of considerable importance. He will derive assistance in the exercise of that authority from the proposals in paragraphs 13.40 to 13.42 concerning the valuation of illiquid assets. An important part of those proposals is that the mutual fund's statement of investment practices should include a list of the types of illiquid assets in which it is to invest, together with valuation techniques to be used. Such lists can be reviewed by the administrator to eliminate any assets which ought to be treated as assets inappropriate for mutual fund investment. In addition, the statements of portfolio can be reviewed to pick out any investments which are treated as liquid when they ought to be treated as illiquid.

12.29 For the reasons set out in this section, we recommend:

(1) that for purposes of the recommendations contained in this chapter, the following terms descriptive of types of transactions should have the following meanings:

(a) a "short sale" is a sale of an investment, usually a security, by a vendor who does not own the investment sold but borrows it for delivery to the purchaser and is under an obligation to effect a subsequent purchase to cover the short sale;

(b) "borrowing money for leverage" is a borrowing of money for investment in the hope that, when invested, the money will yield a rate of return higher than the interest (if any) to be paid on the loan and will thereby increase the earnings of the borrower;

(c) "borrowing money to effect redemptions" is a borrowing of money in preference to the liquidation of investments in order to satisfy requests for redemption;

(d) "writing puts and calls" is the granting or issuance of puts and calls under which the person or organization so doing assumes a legal obligation to buy or to sell a specified investment for a specified price at any time until a certain date;

(e) "commodities futures" are contracts for the purchase and sale of commodities at dates in the future; and

(f) "fixed-term financial commitment" includes the liability of the person or organization which issues or writes a put or a call; liabilities to purchase or to sell commodities under commodities futures; and any other contractual obligation under which a commitment is assumed which is, by the terms of the contract, not capable of liquidation until a future date;

(2) that for purposes of the recommendations contained in this chapter, the following terms descriptive of types of investment should have the following meanings:

(a) "illiquid investments" includes all investments and assets other than liquid investments and assets inappropriate for mutual fund investment;

(b) "liquid investments" includes any asset which satisfies one or more of the following tests:

(i) if it is listed and posted for trading on a stock exchange or is traded regularly in a public trading market and price quotations for it based on such trading are regularly published; or

(ii) if facilities are available to permit the ready disposal of the asset at an amount substantially equal to the price at which it is valued in the determination of net asset value; an investment should not be considered to satisfy this test merely because a company associated with the mutual fund has agreed to purchase the investment to produce liquidity; or

(iii) if it is cash or its equivalent including cash of other countries if conversion into Canadian currency can be readily effected;

but an investment should not be considered to be a liquid investment if the mutual fund which owns it is not in a position to sell it without restraint;

(c) "assets inappropriate for mutual fund investment" includes any asset which satisfies either or both of the following tests:

(i) if, subsequent to its purchase and while it remains part of the assets of the mutual fund, it requires payment of costs or carrying charges of kinds not customary in the maintenance of an investment portfolio; this would, for example, include real estate. The necessity to incur costs on the realization of an investment would not bring it within this test, so that the test would not include mortgages merely because of legal costs to be incurred on their realization; or

(ii) if the investment cannot be sold by the mutual fund without the consent of a third party other than a governmental agency; shares of private companies and securities which the purchaser promises not to resell without the consent of the vendor would be included here;

the administrator should have authority to determine that an asset or class of assets is a liquid investment, an illiquid investment, or an asset inappropriate for mutual fund investment regardless of which definition would otherwise include that asset or class of assets; and

(3) that the following assets should, subject to a contrary determination made by the administrator, be considered to belong in the indicated classes of investments or assets as defined in recommendation (2);

(a) mortgages should be considered to be illiquid investments unless and until a trading market develops in them which satisfies item (i) in the definition of liquid investments;

(b) puts and calls written by others should be considered, like mortgages, to be illiquid investments unless and until a trading market develops in them which satisfies item (i) in the definition of liquid investments; and

(c) securities purchased in private placements, other than those which the purchaser covenants not to resell without the consent of the vendor or a third party which is not a regulatory agency, should be

considered to be illiquid investments; this would include securities as to which a representation of investment intention is given and securities the sale of which requires the consent of a regulatory agency.

The Distinction Between Conventional and Non-Conventional Funds

12.30 As with many other aspects of the regulatory scheme proposed in this report, the conclusions reached in the following sections of this chapter can be explained only against the background of the existing structure of the Canadian mutual fund industry as described in the introductory chapters of this report. In theory there would be no reason to impose any investment restrictions on mutual funds apart from those restrictions which are necessary to ensure their ability to effect redemptions on demand. In practice, the functions served by mutual funds have dictated a different result. The fact that they are sold to so many purchasers for whom they are unsought goods, and that such purchasers usually use them as savings vehicles, has led regulatory authorities to the belief that conservative investment policies are appropriate for mutual funds. This belief is shared by much of the industry. We inquired of Canadian mutual funds whether, in the absence of restrictions which prevented them from doing so, they would borrow money for leverage; 48 of 63 replies were in the negative.

12.31 The factors described in the preceding paragraph have resulted in the imposition of restrictions on investment practices designed to cause mutual funds to adhere to conservative investment policies. These restrictions are considered in detail in the following sections: short selling, borrowing for leverage and similar practices are ordinarily prohibited. While we recognize the reasons which have resulted in these prohibitions, we are reluctant to see them continued. One of the principal thrusts of this report is towards a more highly competitive structure within the mutual fund industry, so that it will better serve the investing public. There is a role, and an important role, to be played by mutual funds with specialized investment objectives and prac-

tices designed to cater to investors with particular needs, even if these mutual funds make use of investment practices inconsistent with the restrictions presently in effect.

12.32 The difficulty with any modification of the existing restrictions on investment practices is that they have been in effect for so long that they have contributed to a public association between mutual funds and conservative investment policies. This is of particular significance in the unsought goods segment of the market. The fact that purchasers for whom mutual funds are unsought goods have concentrated upon rate of return as the way to compare mutual funds has not caused serious difficulties to the time of writing. Difficulties might have arisen if all mutual funds had not been subject to restrictions on investment practices designed to enforce adherence to conservative policies regardless of their investment objectives.

12.33 The factors outlined above have put us in the difficult position of wishing to modify restrictions on investment practices while retaining adequate protection for the purchaser to whom mutual funds are unsought goods. The success of the educational techniques proposed in paragraphs 10.37 to 10.47 would resolve this difficulty, for with it would come the ability on the part of the investing public to discriminate among mutual funds on bases other than rate of return. Here as in Chapter X it is, however, necessary to deal with the period which must elapse before those techniques become fully successful.

12.34 We have concluded that the conflicting objectives can be resolved by the application of restrictions on the techniques that may be used in the sale of shares or units issued by mutual funds which make use of unusual investment practices. For this purpose, we consider unusual investment practices to be, generally, those practices which are presently prohibited for Canadian mutual funds, although under our proposals there would continue to be restrictions on the extent to which those practices could be used by any mutual fund. Our conclusion would be implemented through the creation of a legislative distinction between two classes of mutual funds, which we refer to for convenience as "conventional funds" and "non-conventional funds". Non-conven-

tional funds would be subject to regulatory constraints on their investment practices which would be less rigid than the corresponding constraints applied to conventional funds. The precise differences are discussed in the following sections of this chapter.

12.35 The restrictions in the techniques permisible in the sale of shares or units issued by non-conventional funds would be designed to restrict the extent to which they are sold to purchasers for whom mutual funds are unsought goods and who would not be able to appreciate the full implications of the investment practices available to a non-conventional fund. These restrictions are proposed where relevant elsewhere in this report, but they can be briefly summarized. In paragraph 10.106 we propose that the sale of shares or units of non-conventional funds under contractual plans should be prohibited. In paragraph 14.77, we propose restrictions on the content of advertising material for non-conventional funds, and throughout Chapter XIV we make proposals which would result in disclosure that would stress the unusual investment practices of such mutual funds. Finally, in paragraph 10.87 we propose that the available investment practices should be a relevant factor in a decision as to the reasonableness of sales charges; if it becomes apparent to the administrator that the greater range of investment practices available to a non-conventional fund is giving it an undue competitive advantage, the administrator would be justified in considering whether its sales charges should be reduced.

12.36 Not all non-conventional funds will take advantage of the full range of available investment practices. For example, one might be established with very conservative investment objectives but with non-conventional categorization in order to obtain the right to invest more heavily in illiquid investments. Such a mutual fund would not require, and should not have, the right to effect short sales of securities. Careful attention to the relationship between investment objectives and investment practices should do much to avoid the paradoxical situation discussed in the introductory paragraphs of this chapter.

12.37 In paragraph 12.99 we propose that amendments to the statement of investment objectives and investment practices of a mutual fund should require the approval of holders of its shares or units. A change in categorization would not itself result in a change of the restrictions on investment practices. For that reason, we have concluded that the approval of holders of shares or units should not be a pre-requisite to the selection of conventional or non-conventional categorization, or to the change of category. This does not mean that such a change could be effected in any case; a mutual fund with contractual plans outstanding would have to be a conventional fund. To implement our proposal, each mutual fund operating within the relevant jurisdiction at the effective date of the legislation as defined in paragraph 7.10, would be treated as a conventional fund unless and until notice was received by the appropriate administrator from the mutual fund or its management company that it elected treatment as a non-conventional fund. Newly registering mutual funds could select categorization at the time of registration. In either case, subsequent changes of category would be permissible.

12.38 The proposed distinction between conventional and non-conventional funds is, we think, a feasible way to provide flexibility within the mutual fund industry during the period while the public ability to discriminate among mutual funds is developing. However, the experimental nature of the distinction must be recognized. Non-conventional funds will be permitted to engage in investment practices which have hitherto been prohibited for Canadian mutual funds. For that reason, the restrictions proposed in the following sections are more conservative than we would think necessary if working from a blank slate. For example, the proposed prohibition of transactions involving fixed-term financial commitments may be found to be unnecessarily restrictive. The administrative and legislative bodies concerned should keep the rules under continuing review in their practical operation, and should be prepared to modify them to reflect experience. In any event, the entire regulatory scheme should be reconsidered at the time of the five-year review proposed in paragraph 10.92.

12.39 For the reasons set out in this section, we recommend:

(1) that every registered mutual fund should be categorized as either a

conventional fund or a non-conventional fund;

(2) that the distribution of shares or units of non-conventional funds should be subject to the various restrictions proposed where relevant elsewhere in this report; in particular,

   (a) their sale by contractual plan should be prohibited (paragraph 10.125, recommendation (2));

   (b) the content of their advertising should be restricted (paragraph 14.79, recommendation (8));

   (c) disclosure of the implications of their investment practices should be required (Chapter XIV); and

   (d) any advantages which result from their greater flexibility of investment practices should be taken into account in the determination of the reasonableness of their sales charges (paragraph 10.93, recommendation (7)(a));

(3) that non-conventional funds should be permitted a greater range of investment practices in accordance with the specific recommendations made in the following sections of this chapter, but that not all non-conventional funds should be able to engage in all such investment practices; the statement of investment practices should bear a reasonable relationship to the statement of investment objectives, and changes in either statement should be subject to the requirement for approval recommended in paragraph 12.100, recommendation (4);

(4) that mutual funds operating within the relevant jurisdiction at the effective date of the legislation as defined in paragraph 7.20, recommendation (1), should be presumed to be conventional funds unless and until the mutual fund or its management company notifies the administrator of the selection of non-conventional categorization; mutual funds registering subsequently should select categorization at the time of registration; in either case, change of categories would be permissible;

(5) that the experience under the regulatory scheme proposed in this chapter should be kept under review so that any necessary modifications may be made; in particular, consideration should be given to further modification of the restrictions on investment practices for

non-conventional funds; and

(6) that the necessity for the distinction between conventional and non-conventional funds should be reconsidered at the time of the general review proposed in paragraph 10.93, recommendation (9).

Restrictions on Transactions and Investments

12.40 In paragraphs 12.07 to 12.13 we provide definitions of a number of types of transaction, most of which are prohibited by the statements of investment practices of almost every Canadian mutual fund. We are aware of no mutual fund qualified for sale in Canada that is permitted to effect short sales, to write puts and calls or to assume other types of fixed-term financial commitments. Very few are permitted to borrow money for leverage, although almost all have a limited power to borrow money to effect redemptions. These restrictions on investment practices result in large part from the factors discussed in the preceding section. It is felt that such practices would not be consistent with the conservative investment policies which are considered appropriate for mutual funds.

12.41 Another factor has also influenced the adoption of restrictions on the various types of transaction. This is that they are inconsistent with the continuous availability of the right to redeem because they reduce the liquidity of the mutual fund. Each transaction of these types involves the assumption of a liability. With a short sale the liability is an obligation to purchase the security sold short, regardless of the prevailing market price; with the writing of puts and calls, the liability is an obligation to purchase or to sell a security at a fixed price at any time during the specified period, and with borrowed money the liability is an obligation to repay in accordance with the terms of the loan.

12.42 In our view, liabilities which are capable of being discharged at any time without notice or bonus are not inconsistent with liquidity unless they become substantial in amount. Liabilities incapable of being discharged at any time may cause difficulties because in the event of a large volume of redemptions they could quickly become unduly large by comparison with the total assets of the mutual fund. We have therefore concluded that,

at least during an experimental period as discussed in paragraph 12.38, no mutual fund should be permitted to enter into a transaction which involves the assumption by it of a fixed-term financial commitment as defined in paragraph 12.13; nor should any mutual fund be permitted to borrow money, either for leverage or to effect redemptions, unless the loan can be discharged at any time without notice or bonus. In paragraphs 5.73 to 5.77 we propose additional restrictions on borrowing, including a prohibition of any borrowing not specifically permitted under this chapter.

12.43 In some circumstances, the difficulties which may result if the liabilities of a mutual fund are substantial in relation to its assets could be serious even though the liabilities are capable of discharge without notice or bonus. The brief submitted to us by the Canadian Mutual Funds Association, which takes the position that restrictions on borrowing should be relaxed with a view to their ultimate elimination, states the argument against heavy borrowing in this way: "The danger is simply that, if a fund were faced with a severe market slump and a run of redemptions, it might not be able to sell shares and reduce indebtedness quickly enough to have anything left for the last few shareholders." This possibility has been taken into account in the formulation of the specific proposals made in this section concerning the extent to which conventional and non-conventional funds should be permitted to engage in such transactions.

12.44 Implementation of the conclusion set out in paragraph 12.42 would prohibit mutual funds from engaging in any of the types of transaction referred to in paragraph 12.40 except short sales of securities and borrowing money. Neither short selling nor borrowing is abusive; both are available to other participants in the securities markets, and they should not be denied to mutual funds unless their denial is necessitated by other considerations. Indeed, significant benefits might result from these practices. For example, submissions have been made to us that removal of the prohibitions against short sales by mutual funds would make a material contribution to the nation's securities markets through an improvement in the relationship between supply and demand. We have reached no conclusion on the merits of those submissions, since this argument is not needed to convince us that short sales

should be permitted for mutual funds except to the extent that other considerations dictate the contrary.

12.45 The only "other considerations" that we think relevant in the decision whether mutual funds should be permitted to effect short sales or to borrow money are the difficulties which may result from substantial liabilities, and the traditionally conservative investment practices of the Canadian mutual fund industry which have resulted in our proposed distinction between conventional and non-conventional funds. Because similar considerations are relevant to restrictions on types of investment, the detailed restrictions we propose are discussed below together with those applicable to types of investment. Those restrictions should be supplemented by one qualification applicable specifically to short sales. This is that short sales should be restricted to securities listed on recognized stock exchanges, and should be effected only in accordance with the rules of an exchange upon which the security sold short is listed. Implementation of this conclusion will provide reasonable assurance that short sales are confined to securities in which a trading market exists, and that they are properly implemented.

12.46 Problems of liquidity are raised in a clearer way by the question of what types of investment should be permitted for mutual funds. In paragraphs 12.15 to 12.22 we provide definitions of liquid investments, illiquid investments, and assets inappropriate for mutual fund investment. Our conclusion is that, subject to other recommendations in this report, mutual funds should be permitted to purchase liquid investments without restriction; should be permitted to invest to a limited extent in illiquid investments; and should be prohibited from investing in assets inappropriate for mutual fund investment.

12.47 The definition of liquid investments is self-explanatory and discussion of why we propose no restriction on such investments is unnecessary. One comment should be made concerning the definition. In paragraph 12.18 we state that an asset should not be considered a liquid investment merely because a company associated with the mutual fund has agreed to purchase it to produce liquidity. In a few cases, administrators have permitted mu-

tual funds to invest heavily in illiquid assets because such agreements were available. A good example is the Royal Trust "M" Fund, an investment fund offered for public participation by the Royal Trust Company. This fund invests almost exclusively in mortgages, and the trust company has agreed in the event that liquidity problems are encountered to find a market for the mortgages at 95% of their current valuation. Our conclusion that such an agreement should not be regarded as effective to transform the assets concerned into liquid investments is based on the difficulties we see in its implementation. Questions such as the determination of when the obligation becomes effective; who will enforce it; how the assets to be sold are to be selected; and how and whether competitive bids will be obtained, can all occasion difficulties.

12.48 The definition of assets inappropriate for mutual fund investment is designed to include assets which might be impossible, rather than merely difficult, to sell. Investment in such assets by a mutual fund would be inconsistent with its role as a vehicle for investment; the mutual fund is, in our opinion, not a proper vehicle for the continuing management of a business enterprise. That reason also dictates the other test of an asset inappropriate for mutual fund investment; assets for which it is necessary to pay carrying costs of a kind not usual for an investment portfolio are rarely investments in the ordinary sense, but require continuing management. Any such asset of which this is not true can be dealt with through the exercise of the administrator's discretionary authority to allocate assets or classes of assets to different categories.

12.49 The definition of illiquid investments as all assets other than those included within either of the other two definitions results in the treatment as illiquid investments of a number of items which have long concerned administrators. Mortgages, most letter stock, and puts and calls written by others are all included, and all have been the subject of controversy. Such investments pose obvious problems of liquidity and valuation, but their prohibition for mutual funds would be a serious and undesirable step. Our proposals would permit such investments for non-conventional funds subject to restrictions to avoid resultant difficulties.

12.50 In our determination of the extent to which the various types of transactions and investments should be permitted for mutual funds, we have been influenced by the information summarized in Tables B-1 and B-2 of Appendix "B". This deals with sales and redemptions of shares or units issued by Canadian mutual funds between 1962 and 1967. It indicates that mutual funds are rarely forced to liquidate their holdings to meet demands for redemption. It is, however, important that the period covered by the information was one during which sales of shares or units were at high levels and a major volume of demand for redemptions did not occur. We think it necessary to allow for such an eventuality, and therefore are not prepared to assume that portfolio liquidation to satisfy redemption orders will never be necessary.

12.51 In paragraph 12.45 we note the similarity of the considerations applicable to restrictions on types of transaction and restrictions on types of investment. These similarities have led us to conclude that the restrictions should be closely related. Conventional funds should be prohibited from effecting short sales or borrowing money for leverage, and should also be prohibited from purchasing puts and calls written by others. They should be permitted to purchase illiquid investments and to borrow money to effect redemtions; in each case, the amount involved (the amount borrowed or the value of the illiquid investments) should at no time exceed 15% of the total net assets of the mutual fund. The applicable percentage is the same for the two cases because this protection against the inability to sell illiquid investments seems desirable; the percentage is determined on the basis of the information summarized in Appendix "B".

12.52 Non-conventional funds should be permitted to effect short sales, to borrow money for leverage, to borrow money to effect redemptions, and to purchase illiquid investments. We have concluded that the restrictions on these activities should be embodied in a single test designed to recognize the relationship among them. A non-conventional fund should be permitted to borrow more heavily if it does not also purchase illiquid investments than if it does, for the problems of liquidity would be accentuated in the latter case. For purposes of the test, borrowing money for leverage, borrowing money to

effect redemptions, and short sales should be considered together as liabilities.

12.53 We have concluded that a non-conventional fund which has no liabilities should be permitted to invest up to 40% of its total net assets in illiquid investments. On the other hand, a non-conventional fund which owns only liquid investments should be permitted to have liabilities of up to 75% of its total net assets. This would mean that a non-conventional fund with total net assets of $1,000 could purchase illiquid investments with a value of not more than $400, if it had no liabilities for borrowed money or securities sold short; or, alternatively, it could borrow $750 or effect a short sale of securities with a value of $750, if it owned no illiquid investments. In order to combine these restrictions so that a mutual fund could have liabilities and also own illiquid investments but could not simultaneously do both to the extent that would be permissible if either were done alone, we propose adoption of an inclusive test which makes use of a borrowing base.

12.54 The borrowing base of a non-conventional fund at any time would equal its total net assets (the excess of its assets over its liabilities) less the then value of its illiquid investments. The maximum permitted holdings of illiquid investments would be 40% of total net assets, but the maximum permitted liabilities would be 75% of the borrowing base; in the absence of any illiquid investments, the borrowing base would equal total net assets, so that the extent of the power to incur liabilities would be restricted only by holdings of illiquid investments.

12.55 The operation of the restrictions we propose can be clarified by an example. A mutual fund with total net assets of $1,000 could make illiquid investments to the extent of $400. If it did so, its borrowing base would be reduced to $600, and it would be permitted to incur liabilities for borrowing or short selling only to the extent of $450 (75% of $600). If it did not invest in illiquid assets, it would be permitted to incur such liabilities to the extent of $750. It should be remembered that total assets are increased by borrowing and short selling, although total net assets are unaffected. When a mutual fund with $1,000 in total net assets borrows $600, its

total assets increase to $1,600 while its total net assets remain unchanged. That is why the restrictions we propose are based on total net assets rather than total assets.

12.56 Because liability for securities sold short fluctuates with variations in the market price of the securities in question, the application of our proposed restrictions to the short sale of securities involves complications which should be considered. If it is assumed that the non-conventional fund with total net assets of $1,000 effects short sales of securities to a value of $750, it could not thereafter incur further liabilities or purchase illiquid investments. If, however, the value of the securities sold short fell to $600, the total net assets of the non-conventional fund would rise to $1,150, and it would then be able to incur liabilities for borrowed money or securities sold short to the extent of an additional $262.50, so that its total liabilities would be $862.50 being 75% of $1,150. Alternatively, it could invest in illiquid assets to the extent of $350; while this amount is less than 40% of total net assets, it would reduce the borrowing base to $800, of which the $600 liability would be 75%.

12.57 The fact that the proposed restrictions on non-conventional funds treat liabilities for money borrowed to effect redemptions together with liabilities for short sales and for money borrowed for leverage will impose a restraint on the prudent investment manager. To allow for the possibility of a large volume of redemptions, he should maintain some borrowing power in reserve so that he will be able to borrow money to effect those redemptions. We have concluded that this should be left to the judgment of the investment manager, and that regulatory requirements are not necessary to ensure it is done. Other types of liabilities should also be taken into account. A mutual fund may have liabilities for administrative expenses, of which the most important would be management fees. While such other liabilities are not directly subject to our recommended restrictions, they affect the operations of these restrictions. For example, in the preceding paragraph the facts suggest maximum use by the non-conventional fund of its powers. It would be in default under the proposed restriction if total net assets were to be reduced through a liability for management fees.

12.58 The requirements concerning financial disclosure proposed in Chapter XV would not always result in disclosure of the extent to which the powers proposed in this section were used. If money was borrowed and the loan repaid, the transaction would not be specifically referred to in the financial statements. This could be important information, and we have concluded that each prospectus and annual and semi-annual report of a non-conventional fund should include a note describing the extent to which the power to borrow money for leverage and the power to borrow money to effect redemptions have been used during the period reported on. The prospectuses and reports of a conventional fund should include a corresponding statement concerning the power to borrow money to effect redemptions. Information concerning short sales would be included in the statement of portfolio transactions under paragraph 15.40.

12.59 We have considered whether the few mutual funds that presently engage in investment practices which would be prohibited under the restrictions proposed in this section ought to be granted an exemption from these restrictions. Our conclusion is that no such exemption would be desirable. The restrictions are proposed for investor protection, and are as important for existing mutual funds as for newly organized mutual funds. In addition, to confer an exemption on existing mutual funds might provide them with an unfair competitive advantage. Finally, it is important to note that the operation of the restrictions we propose can be avoided through the creation of a closed-end investment company.

12.60 For the reasons set out in this section, we recommend:

(1) that the terms defined in paragraph 12.39 should have the meanings there set out as used in the following recommendations;

(2) that no mutual fund should be permitted to enter into a transaction which involves the assumption by it of a fixed-term financial commitment;

(3) that no mutual fund should be permitted to borrow money for leverage or to borrow money to effect redemptions unless the loan can be discharged by the mutual fund at any time without notice or bonus; other

borrowing would be prohibited under paragraph 5.78, recommendation (1);

(4) that, to the extent that short sales are permitted under the following recommendations, they should not be effected except in securities listed on recognized stock exchanges, and should be effected only in accordance with the rules of an exchange upon which the security sold short is listed;

(5) that mutual funds should be permitted to purchase liquid investments without restriction; should be permitted to purchase illiquid investments in compliance with the restrictions proposed in recommendations (6) and (8); and should be prohibited from purchasing assets inappropriate for mutual fund investment;

(6) that a conventional fund should:

(a) be prohibited from effecting short sales;

(b) be prohibited from borrowing money for leverage;

(c) be prohibited from purchasing puts and calls written by others;

(d) be permitted to purchase illiquid investments, subject to clause (c), provided that the total value of illiquid investments held by it should at no time be in excess of 15% of its total net assets; and

(e) be permitted to borrow money to effect redemptions, provided that the liability for money so borrowed should at no time exceed 15% of its total net assets;

(7) that, for purposes of recommendation (8), the borrowing base of a non-conventional fund at any time is the excess of its total net assets (being its assets less its liabilities) over the then value of illiquid investments owned by it;

(8) that a non-conventional fund should:

(a) be permitted to purchase illiquid investments provided that the total value of illiquid investments held by it should at no time be in excess of 40% of its total net assets; and

(b) be permitted to effect short sales, to borrow money for leverage and to borrow money to effect redemptions, provided that its

total liabilities for all three should at no time be in excess of 75% of its borrowing base;

(9) that each prospectus, annual report, and semi-annual report of a mutual fund should include a note describing the extent to which the power to borrow money to effect redemptions has been used during the period reported on; in the case of non-conventional funds, the note should also contain a similar description concerning the use of the power to borrow money for leverage; and

(10) that no exemption from the preceding recommendations should be provided for existing mutual funds.

<u>Restrictions on the Extent of Investments Permissible in Securities of Any One Issuer; the Problem of Portfolio Company Relationships</u>

12.61 Perhaps the most controversial of the restrictions on investment practices of mutual funds are those concerning the extent of investments permissible in securities issued by a single company. In our consideration of these restrictions and the problems they involve, we have had the benefit of extensive reports prepared by Professors Leslie Wong and Peter Lusztig, and by Professor Daniel Baum. In addition, we have had a number of discussions with participants in the mutual fund industry. In the following discussion we summarize the existing restrictions applicable to Canadian mutual funds and the problems with which they are designed to deal, before briefly setting out our approach to these problems.

12.62 Most securities administrators require that the statement of investment practices of a mutual fund include restrictions on the extent to which it will invest in the securities of any one issuer. Such a restriction is also contained in the regulations of the Canadian Mutual Funds Association. The relevant provision of the latter regulations is a good example both of the type of restriction generally applied and of the problems it creates. Until 1968 the C.M.F.A. prohibited member mutual funds from the purchase of securities of any one issuer if upon such purchase more than 10% of the net assets of the mutual fund would consist of securities of that issuer or the mutual fund would own more than 10% of the outstanding securities of that issuer. Limited exceptions were provided, including one for

securities issued or guaranteed by Canada, any province thereof, or the Government of the United States of America. This restriction was substantially similar to those which were and are embodied in the prospectuses of most Canadian mutual funds.

12.63 In 1968 it became apparent that the rule outlined above was unduly restrictive in its application to some of the larger C.M.F.A. members, which include the largest Canadian mutual funds. The regulation was therefore amended by the addition of an alternative provision that permitted the 10% limit on holdings in one portfolio company to be exceeded under certain conditions. The new provision permits a mutual fund to acquire in excess of 10% of the outstanding securities of an issuer, provided that not more than 5% of the total net assets of the mutual fund are so invested and that not more than 10% of the issuer's voting securities are acquired. A provision is also included to prevent the acquisition of such a large interest in a company associated with the mutual fund or the management company. Those responsible for the investment management of some of the large mutual funds have advised us that but for this amendment they would have found it difficult to make substantial further investments in Canadian securities.

12.64 Restrictions on investment by a mutual fund in securities of a single issuer are motivated by two principal factors: the desire to prevent the acquisition of control over portfolio companies and the desire to prevent undue portfolio concentration. The former is considered first in this discussion. A mutual fund collects money from many participants for management by persons to whom the responsibility is delegated. This raises problems of conflicts of interest, to some of which Chapter IX is devoted. One possible consequence of this delegation of responsibility is the use by the investment managers of securities held by the mutual fund to exercise authority over the public companies that are the issuers of such securities. A considerable portion of the reports and discussions referred to in paragraph 12.61 has been devoted to whether such use of power is good or bad. We do not think a detailed analysis of this question is necessary; our conclusions are well expressed in the following quotation from a brief submitted to us on behalf of a Canadian mutual fund:

The basic business of a mutual fund should, we believe, be portfolio investment, not control of the companies in which they have holdings. As has already been stated, portfolio investment has as its objective the achievement of a maximum return on investment within acceptable limits of risk and acquiring a controlling interest in one or more companies may well have the effect of increasing the risks involved without necessarily maximizing the return on investment. For this reason, we feel that great care should be exercised by portfolio managers not to become so heavily invested in any one company that they must become deeply involved in its management if something goes wrong. Aside from any other consideration, investment management organizations are normally not equipped to assume the responsibilities of direct management.

This is not to say, however, that there should not be a close relationship between the management of mutual funds and the companies whose securities they hold. The management of a mutual fund is representing its own individual shareholders in all its investments and should, if anything, act even more responsibly in its dealings with portfolio companies than would the individual shareholder himself. We, ourselves, have on several occasions been consulted by the management of a portfolio company on matters of shareholder relations and, on other occasions, have felt free to make suggestions when we felt competent to do so. Experience has taught us, however, to avoid placing ourselves in a position where we have lost our freedom to sell our shares if, for any reason, we feel that our money could be better employed elsewhere.*

12.65 We are satisfied that the above quotation represents the views of the great majority of participants in the Canadian mutual fund industry, and that the position it takes is in the public interest. It is desirable for mutual funds to act as responsible shareholders, but it is not desirable for them to take control of public companies. Apart from the factors referred to in the quotation, we think that serious harm could result if a mutual fund were to assume control over a public company, with all that implies in terms of disruption of the normal routine of the company, only to sell it as a result of a changed investment policy, perhaps dictated by factors completely unrelated to the company concerned. Our conclusion that mutual funds should not acquire control of public companies is based on the nature of mutual fund operations, and is not intended to have any implications concerning other types of investment companies.

12.66 The quotation in paragraph 12.64 describes a very fine line: it is inappropriate for a mutual fund to acquire control over portfolio companies, but it is appropriate for a mutual fund to participate in their

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* United Bond & Share Limited, RoyFund Distributors Limited and RoyFund Ltd. Brief to the Canadian Committee on Mutual Funds and Investment Contracts: (June, 1968) page 30.

affairs as a responsible shareholder. While we recognize the difficulties in application of this distinction, we accept both parts of it. The fact that the distinction is also accepted by the great majority of participants in the mutual fund industry and is consistent with the public interest makes detailed analysis unnecessary, and there is only one point that we think should be added to the remarks made in the quotation. This is that, speaking generally, Canadian mutual funds are very reluctant to take active roles as shareholders of their portfolio companies. Many follow unvarying rules in their treatment of proxies, usually that they will be completed in favour of management, and do not oppose even the most inefficient management. Instead, when dissatisfied with a portfolio company the tendency is for the mutual fund to sell its shares. We do not quarrel with this approach, but we would like to see Canadian mutual funds take more seriously their roles as shareholders. Responsibly exercised, the authority conferred by their shareholdings could enable them to make a significant contribution to corporate management.

12.67 The second factor which motivates the adoption of restrictions on investment by a mutual fund in securities of a single issuer is the desire to prevent undue portfolio concentration, an objective closely related to the liquidity considerations with which the preceding section of this chapter is largely concerned. We recognize the dangers in undue concentration, and have concluded that some regulatory restriction is needed. However, the restriction need not be rigorous for principal reliance can appropriately be placed on the business judgment of investment managers. The quotation in paragraph 12.64 accurately represents their desire to avoid an undue commitment to any single issuer.

12.68 We have concluded that the restrictions designed to prevent undue concentration and those to prevent the acquisition of control cannot feasibly be incorporated in a single rule and that they should be separately considered. On concentration the important question is what percentage of the mutual fund's assets are invested in a single issuer; on control the important question is what percentage of the securities of an issuer are owned by a mutual fund. A large mutual fund could own a majority of the shares of a small

company with no problem of concentration, but there would be a serious problem of control. On the question of concentration, we have concluded that conventional funds should be prohibited from the investment of more than 10%, and non-conventional funds from the investment of more than 15%, of their total net assets in securities of a single issuer. This restriction, unlike the restrictions proposed in the preceding section, would be a transaction test rather than a maintenance test. No purchase of portfolio securities could be implemented if as a result of such purchase the relevant restriction was breached, but it may sometimes happen that holdings of a particular security will exceed the limit because of an accretion in value of the security or for other reasons apart from a purchase. We do not believe that in such situations a mutual fund should be obligated to dispose of a portion of its holdings so that the test would again be satisfied.

12.69 Restrictions appropriate to prevent the acquisition of control present more serious problems because of the difficulty in an adequate definition of the word "control". Few words have been defined in more different ways, and with less success. It seemed desirable to formulate our approach to the problem on the basis of an analysis of the existing situation, and we derived considerable assistance in so doing from the report prepared by Professors Leslie Wong and Peter Lusztig. On the basis of an extensive analysis based on personal interviews and on studies of the holdings of mutual funds and other institutional investors, they concluded:

> It became obvious ... that where the attractiveness of common shares were compelling enough to overcome the reluctance of investment managers to forego portfolio mobility, the same attractiveness was discernible to other investors including financial institutions. Thus, countervailing power developed and was in evidence. On the premise that such effective checks will prevail, no legislation is required. There was no evidence of concentration by investment companies in securities unattractive to other financial institutions. Any such isolated concentrations would imply the pursuit of control.

While we do not accept the conclusion of Professors Wong and Lusztig that no legislation is required to prevent mutual funds from acquiring control over public companies, we have relied on their findings and similar findings of our staff in our conclusion that the usual rule which prohibits the acquisition of more than 10% of an issuer's voting securities is not appropriate to deal with the control problem.

12.70 As indicated in paragraph 12.68, a restriction designed to prevent the acquisition by mutual funds of control over portfolio companies should relate to the percentage of securities of the portfolio companies held by the mutual funds, rather than to the percentage of the mutual funds' assets represented by such securities. The usual rule considers each mutual fund separately for this purpose. We have concluded that this approach does not adequately deal with the situation which frequently arises, where a single management company is associated with several mutual funds. In such cases the mutual funds should be treated together, for otherwise the common management company could make use of the combined holdings of several mutual funds to put itself in a control position. Accordingly, in the conclusions which follow the phrase "related mutual funds" is used to denote mutual funds under common management, whether they are conventional or non-conventional funds, and each of a group of related mutual funds is considered to be related to the others in the group. We have concluded that a mutual fund should not be permitted to effect a purchase of securities of any class of any issuer if as a result of such purchase its aggregate holdings of that class together with the holdings of related mutual funds exceed 20% of outstanding securities of the class, by number or dollar value.

12.71 While implementation of the conclusion in the preceding paragraph would reduce the possibility of acquisition by mutual funds of control over portfolio companies, it would not alone be sufficient for that purpose. It should be supplemented by a provision that when the combined holdings of related mutual funds exceed 10% of the voting securities of a company, that company should be treated as an associate of each mutual fund for purposes of application of the legislation recommended in Chapter IX. This means that further acquisitions of any securities of such company by any of the related mutual funds would be prohibited unless advance approval was obtained from the administrator. This approval should be granted only if the administrator is satisfied that the acquisition is not designed to enable the mutual fund to exercise control over the portfolio company. The suggested rule would also mean that transactions entered into with the company by any of the related mutual funds which fell within any of the categories listed in para-

graph 9.45 would be subject to a reporting requirement. It is important to note that this addition to the general rule proposed in the preceding paragraph relates only to voting securities; associate status would not arise as a result of holdings of other classes of securities.

12.72 The conclusions reached in the two preceding paragraphs should be considered together. So considered, their implementation would mean that no more than 20% of any class of securities of a portfolio company could be acquired by related mutual funds; when over 10% of the voting securities of a portfolio company were held by related mutual funds, they could not acquire additional securities without consent of the administrator. Even with such consent, the maximum permissible holdings of any class would continue to be 20%. As with the proposed restriction in paragraph 12.68 on the percentage of total net assets of a mutual fund that may be invested in securities of a single issuer, each of these tests should be a transaction test rather than a maintenance test.

12.73 Two exceptions should be made to the restrictions proposed in this section. It will be noted that they would prevent the acquisition by mutual funds of subsidiary companies, a consequence that we consider appropriate except in limited circumstances. We have concluded that an exception should permit the acquisition of a wholly-owned subsidiary, provided that it engages in no activities that would not be permissible if carried on by the mutual fund itself, and further provided that its financial information is fully consolidated with that of the mutual fund for reporting purposes. Another consequence of the restrictions is that they would prevent the organization of a mutual fund to invest exclusively in shares or units issued by a single other mutual fund. These mutual funds are discussed in paragraph 12.90, 15.70 and 15.71. They serve worthwhile functions, and should be exempted from the proposed restrictions on the extent of permissible investment in a single portfolio company.

12.74 For the reasons set out in this section, we recommend:

(1) that mutual funds should be subjected to restrictions designed to prevent the acquisition by them of control over portfolio companies,

but should be encouraged to make use of their influence as shareholders of such companies in the best interest of mutual fund participants and of the investing public;

(2) that, to prevent undue portfolio concentration, conventional funds should (subject to recommendation (4)) be prohibited from the investment of more than 10% and non-conventional funds from the investment of more than 15% of their assets in securities of a single issuer; this restriction should operate with respect to each transaction rather than as a maintenance test;

(3) that, to prevent the acquisition of control over portfolio companies, the following provisions should (subject to recommendation (4)) be applied; the term "related mutual funds", should be defined to include mutual funds under common management:

(a) no mutual fund should be permitted to purchase securities of any class of any issuer if after such purchase the holdings of that mutual fund and of related mutual funds exceed 20% of outstanding securities of such class, by number or dollar value; and

(b) the term "associates of a mutual fund" as defined in paragraph 9.32, recommendation (2) should be expanded so that any public company in which a mutual fund, alone or together with related mutual funds, holds in excess of 10% of the voting securities would be an associate of the mutual fund and of each of the related mutual funds; and

(4) that exceptions should be embodied in legislation which implement recommendations (2) and (3) to permit:

(a) the acquisition by a mutual fund of a wholly-owned subsidiary company, provided: (i) that such subsidiary company engages in no activities that would not be permissible if carried on by the mutual fund itself; and (ii) that the financial information of the subsidiary company is fully consolidated with that of the parent for reporting purposes; and

(b) the operation of a mutual fund which invests exclusively in shares or units issued by a single other mutual fund.

Restrictions on Investment in Shares or Units Issued by Other Mutual Funds

12.75 One result of the success experienced by the Canadian mutual fund industry in recent years has been pressure by entrepreneurs to be permitted to organize mutual funds to invest in shares or units issued by other mutual funds; for convenience, in the following discussion we refer to such mutual funds as "funds on funds". One fund on funds has in fact been organized, and is qualified for sale in the province of British Columbia; at March 31, 1969 this mutual fund, Great Pacific Fund Ltd., had total net assets of $1,425,407. It is reasonable to assume that additional funds on funds would be organized but for resistance from the various administrators. The interest in funds on funds is largely inspired by the success of The Fund of Funds, Ltd., a mutual fund incorporated in Ontario but with headquarters in Geneva; at the time of writing, The Funds of Funds, Ltd. is qualified for sale neither in Canada nor in the United States.

12.76 In its Public Policy Report*, the Securities and Exchange Commission considered funds on funds and arrived at a conclusion adverse to them. Because of the potentiality of influence by the fund on funds over the mutual funds held in its portfolio, and through them over their portfolio companies; the duplication of sales charges and management fees when one mutual fund invests in the shares or units of another mutual fund; and the lack of utility of the fund on funds from the viewpoint of the investor, the S.E.C. proposed that the creation and operation of funds on funds should be prohibited. We agree that funds on funds involve serious potential difficulties which must be considered and dealt with. We have, however, concluded that they should not be prohibited.

12.77 One point is, in our opinion, clear. Investment by a mutual fund in shares or units of another mutual fund should be restricted to cases where the former mutual fund is organized for the purpose of making such invest-

* Supra, footnote to paragraph 1.07, at pages 311-324.

ments. If mutual funds generally could invest in other mutual funds at will, potentially serious situations could result. The consequence would be sub-delegation of investment management without the authority of the persons whose money was involved. Holders of shares or units in a mutual fund which is not a fund on funds expect their money to be managed by the management company of that mutual fund, not by the management company of another mutual fund in which that mutual fund invests. Other consequences would include a potentially chaotic situation of cross-ownership and interlocking between and among mutual funds which might produce results inconsistent with the regulatory scheme proposed in this report. Finally, it would be impossible to apply the specific restrictions on funds on funds proposed in the following paragraphs if any mutual fund could invest in shares or units of other mutual funds. We have therefore concluded that the only mutual funds permitted to make such investments should be funds on funds.

12.78 Implementation of the conclusion that funds on funds are the only mutual funds which should be permitted to invest in other mutual funds will necessitate a specific prohibition of such investments by mutual funds other than funds on funds. The reverse does not, however, follow: a requirement that funds on funds invest exclusively in other mutual funds would be unduly rigorous. We have concluded that a fund on funds should be permitted to hold other investments with a total value which should at no time exceed 20% of its total net assets. In addition, to provide flexibility of investment management a fund on funds should be permitted to hold cash or bank deposits without restriction.

12.79 Our conclusions concerning the extent to which mutual fund investment in other mutual funds should be permitted do not resolve the problems which persuaded the Securities and Exchange Commission to propose the abolition of funds on funds. The first of these problems is the power which the management company of the fund on funds has or may have over the mutual funds held in its portfolio, and through them over their portfolio companies. A substantial holding by one mutual fund in another mutual fund exposes the latter to

the possibility of a redemption which might force a liquidation of portfolio securities, and would reduce total net assets and management fees. The power to effect such a redemption might be used by the management company of the fund on funds to exert influence over the policies of the underlying mutual funds.

12.80 Certain proposals made elsewhere in this report are relevant to the problem of influence by a fund on funds over underlying mutual funds. In paragraphs 13.89 to 13.98 we describe circumstances in which a mutual fund should be permitted to deliver portfolio securities in satisfaction of requests for redemption. The availability of this right will do much to alleviate the dangers of forced liquidation resulting from a sudden redemption request. In paragraphs 13.80 to 13.87 we propose a penalty for short-term redemptions which would prevent abuses through redemptions made by a fund on funds shortly after purchase of the shares or units of another mutual fund. In paragraphs 12.61 to 12.73 we propose restrictions on the extent of the investment which a mutual fund may make in a portfolio company; these restrictions would apply to funds on funds. Helpful though these proposals may be to alleviate the potential problems in this area, we have concluded that they are not alone sufficient.

12.81 We have concluded that strict limitations should be applied on the extent of investment permitted by a fund on funds in an underlying mutual fund. The restrictions proposed in the preceding section on the percentage of the assets of a mutual fund which may be invested in a single portfolio company are adequate in this context, but those concerning the percentage of the securities of a company which may be acquired by a mutual fund are inadequate. We have concluded that a fund on funds should not be permitted to acquire shares or units of another mutual fund if, after such acquisition, the fund on funds, alone or together with other funds on funds under common management, would hold in excess of 3% of the outstanding shares or units of that mutual fund. This percentage limit corresponds to that contained in section 12(d)(1) of the Investment Company Act of 1940, and we think it appropriate for adoption in Canada.

12.82 In order to enforce the restriction proposed in the preceding paragraph, it should be supplemented by a prohibition against the issuance of shares or units by a mutual fund if that mutual fund, its management company or its distribution company is aware that the shares or units are intended for acquisition by a fund on funds (whether or not registered in Canada) that would, after the acquisition, be in contravention of the proposed restriction. This prohibition should be effective to restrict the extent of investment by a fund on funds in a single other mutual fund to a level at which the influence discussed by the S.E.C. would not be a substantial problem.

12.83 The second principal reason which led the S.E.C. to conclude that funds on funds should be prohibited was the duplication of management fees and sales charges which results when one mutual fund invests in another mutual fund. This is closely related to the third reason, that the fund on funds performs no useful function for the investor. As indicated below, we are not prepared to accept the third reason, and must therefore assume that some useful purpose is served by the fund on funds. That assumption provides some justification for a duplication of management fees and sales charges, but further analysis is required of both types of charges.

12.84 One restriction is, we think, clearly necessary to prevent undue duplication of sales charges and management fees. A fund on funds ought not to invest in other funds on funds; such an investment would result in expenses incommensurate with any benefits obtained. Even where the investment is directly in other mutual funds, special considerations are applicable. In paragraph 10.88 we describe investment objectives as a factor relevant to the determination of the reasonableness of management fees and sales charges, and refer to the fund on funds as an example. Although we conclude below that the investment manager of a fund on funds has a responsible task to perform it is doubtful that the task is as onerous as that involved in the management of most other mutual funds. For that reason, the administrator or court concerned with the decision may feel that a reasonable management fee for a fund on funds should be lower than that for other mutual funds.

12.85 Additional considerations are relevant to sales charges. If a fund on funds the shares or units of which are sold to the public at the maximum prevailing sales charge rate invests in other mutual funds at the same rate, it is apparent that the costs involved will be such as to make the entire arrangement uneconomic from the investor's viewpoint. Funds on funds should be in a position to derive maximum advantage from sales charge competition, and we have concluded that they should be expected and required to do so. A fund on funds should, therefore, not be permitted to pay a sales charge on its investment in an underlying mutual fund which exceeds the prevailing rate for large volume purchases. For certainty, that rate should be specified from time to time in a regulation which reflects existing practice in the Canadian industry. The regulation would in no way affect sales charge rates; it would only indicate what the administrator felt to be prevailing rates on volume transactions. We have concluded that it ought initially to restrict the sales charges paid by funds on funds to 1% of the amount invested in the underlying mutual fund (rather than the amount paid by the purchaser).

12.86 Perhaps the most important reason advanced by the S.E.C. in support of the prohibition of funds on funds was their lack of utility for the investor, as indicated by the following quotation:

> It is also argued that the fund holding company is a desirable investment vehicle because the proliferation of mutual funds, with varying records of performance, makes it difficult for the investor to choose the best performing funds. While this proposition would perhaps at first appear plausible, closer analysis indicates the contrary.
>
> A mutual fund investment offers professional management of a diversified portfolio. Once an investor elects this method of investing, he must, of course, make an investment decision in which he selects a professional investment manager (i.e., a specific mutual fund). It is the investor alone who must make this investment decision. If it is true that "professionals" are needed to choose among a group of professionally managed mutual funds, it is equally true that professionals will be needed to in turn choose the professionals. If funds on funds are permitted to proliferate, how would an investor decide among the many such companies seeking his investment dollar? Would he not need a fund on funds on funds to make this decision?*

The passage from which the quotation is taken goes on to point out that the

* Public Policy Report (supra, footnote to paragraph 1.07) page 321; underlined portion italicized in original.

limited number of mutual funds available, and the comparatively small investment permitted in each, will probably combine to force the manager of the fund on funds to invest in at least some mutual funds which are of indifferent quality. While we recognize that these points have merit, we have concluded that they are insufficient to justify the denial to the investor of this type of vehicle.

12.87 We are fortified in our conclusion by the fact that we attach greater significance than does the quotation in the preceding paragraph, to the task performed by the investment manager of a fund on funds. This is because of the problems presented to the investor by the proliferation of mutual funds. On the one hand, as noted in paragraph 3.08, analysts are unanimous in their opinion that investment management cannot be properly assessed on the basis of a history of less than five year's results; on the other hand, many mutual funds that seem worthy of attention have been in existence for less than five years or have changed management during the five-year period. This requires that investment management be assessed in other ways, a task often beyond the competence of the investor (as even an assessment on the basis of historical results may be). Finally, since a mutual fund is only as good as its investment management, it may sometimes be advantageous to sell shares or units of one mutual fund and purchase shares or units of another following a change in investment management of the first. We do not contend that these responsibilities are sufficient to make the task of a fund on funds investment manager as onerous as that of other investment managers, but the difference should be reflected in decisions on the reasonableness of management fees rather than in a prohibition of funds on funds.

12.88 One additional restriction on the investment activities of funds on funds is, we have concluded, made necessary by the distinctive nature of the regulatory scheme that we propose for application to mutual funds. For a fund on funds to invest in securities issued by mutual funds which are not subject to that scheme would reduce its effectiveness, and might result in abuses. We have therefore concluded that funds on funds registered in Canada

should not be permitted to invest in shares or units of any mutual fund that, at the time of purchase, is not registered in a jurisdiction of Canada that has in effect legislation which implements the recommendations made in this report. This restriction should be supplemented by a provision which permits the administrator to extend the scope of permitted investments to mutual funds that are subject to the laws of other jurisdictions which provide substantially similar protection.

12.89 A fund on funds, like any other mutual fund, should be categorized as conventional or non-conventional. A conventional fund on funds would be permitted to invest in non-conventional mutual funds, provided such investment was contemplated by its statement of investment objectives and practices. The decision as to the category appropriate for a fund on funds would be made, as with other mutual funds, through a determination by its organizers of whether it should take advantage of the wider range of investment practices available to non-conventional funds. The investment practice which would be most likely to persuade them to adopt non-conventional categorization would be the right to borrow money for leverage.

12.90 One type of mutual fund should be exempted from the requirements proposed in this section. For income tax and other reasons, a number of mutual funds are organized to invest exclusively in the shares or units of a single other mutual fund. These mutual funds are discussed in paragraphs 15.70 and 15.71, and elsewhere in this report. They do not involve the problems considered in this section, and should not be classified as funds on funds. The exemption should be conditional on the arrangement between the mutual fund and the other mutual fund in which it invests being such that duplication of sales charges and management fees is avoided.

12.91 For the reasons set out in this section, we recommend:

(1) that for purposes of the following recommendations, and subject to recommendation (9) a "fund on funds" should mean a mutual fund organized to invest in the shares or units of other mutual funds;

(2) that investment by mutual funds in other mutual funds should be prohibited, except in the case of investments made by funds on funds in compliance with the restrictions proposed in the following recommendations;

(3) that a fund on funds should be permitted to hold investments apart from shares or units of other mutual funds, provided that the value of such investments should at no time exceed 20% of its total net assets; except that holdings of cash and bank deposits should not be restricted;

(4) that, notwithstanding other recommendations in this chapter, a fund on funds should not be permitted to acquire shares or units of a mutual fund if, after the acquisition, the fund on funds would, alone or together with other funds on funds under common management, hold more than 3% of the outstanding shares or units of that mutual fund;

(5) that a mutual fund should be prohibited from the issuance of shares or units if it, its management company or its distribution company is aware that they are intended for acquisition by a fund on funds (whether or not registered in Canada) which would, after the acquisition, be in contravention of recommendation (4);

(6) that a fund on funds should be prohibited from investment in other funds on funds;

(7) that in the acquisition of shares or units issued by other mutual funds the fund on funds should not be permitted to pay a sales charge in excess of a rate determined from time to time by regulation to be the sales charge currently prevailing in the Canadian mutual fund industry for large volume purchases; such rate should be initially established at 1% of the amount invested by the fund on funds;

(8) that a fund on funds should not be permitted to invest in a mutual fund which, at the time of purchase, is not registered in a jurisdiction in Canada that has in effect legislation which implements the

recommendations made in this report; the appropriate administrator should have power, by regulation, to extend the range of permitted investments to mutual funds which are subject to the laws of other jurisdictions that provide substantially similar protection; and

(9) that a mutual fund which invests exclusively in the shares or units of a single other mutual fund should be considered not to be a fund on funds for purposes of the above recommendations, if the arrangement between it and the mutual fund in which it invests is such as to avoid duplication of management fees and sales charges.

Consequences of Failure to Satisfy Investment Restrictions

12.92 Many of the restrictions proposed in this chapter are framed as maintenance requirements, to which the affected mutual funds would be required to adhere on a continuing basis. This is true, for example, of the test proposed in paragraphs 12.53 to 12.57 which would govern the maximum amount of illiquid investments and the maximum liabilities of non-conventional funds. It is apparent that such restrictions can be contravened without deliberate default on the part of any person. Contraventions could even result from actions that were to the credit of management; an increase in the value of an illiquid investment could result in a violation of the applicable limitation on the proportion of total net assets which may be represented by such investments.

12.93 It would obviously be inappropriate to punish all contraventions of maintenance tests as offences. On the other hand, the proposed restrictions are all necessary for investor protection and must be enforced somehow. A similar problem is presented by the minimum capital requirements proposed in Chapter VII, and we conclude in paragraphs 7.60 to 7.68 that their contravention should not be automatically punished but should result in negotiations between management and the appropriate administrator. We have concluded that a similar result should apply to the maintenance requirements proposed in this chapter, and that the conclusions there reached are fully applicable here.

12.94 For the reasons set out in this section, we recommend:

> that the procedures and requirements proposed in paragraph 7.69 should be applicable, with necessary changes, to any contravention of investment restrictions proposed in this chapter which are designed to require compliance on a continuing basis rather than at the time of each transaction.

Statements of Investment Objectives and Practices

12.95 As stated in the introductory paragraphs, this chapter deals principally with the restrictions on investment practices applicable to mutual funds rather than with their investment objectives. This should not be allowed to obscure the importance of the statement of investment objectives. It provides the only indication available to the potential investor of the philosophy of investment management followed in operation of the mutual fund, including the degree of risk which will be accepted. The statement of investment practices indicates only the means available to attain the specified objectives. In view of the importance of statements of investment objectives, it is unfortunate that their language is customarily vague. We recognize that complete precision is unattainable, but many of the statements we have reviewed seem to have been prepared in an effort to appeal to every type of investor. The paradox described in the introductory paragraphs, that the vague investment objectives are often more helpful than the precise investment practices, arises in spite of rather than because of this imprecision.

12.96 In our opinion, statements of investment objectives can and should be made more helpful to the investor than is presently the case, and administrators should press for more precision in their preparation. They should also press for a closer relationship between investment objectives and investment practices, particularly in the context of non-conventional funds. Mutual fund organizers should be discouraged from the tendency to adopt the widest possible statement of investment practices, unless such a statement seems necessary to carry out the investment objectives.

12.97 Another desirable change in statements of investment practices would be for them not only to reflect the restrictions to be accepted in the investment management of the mutual fund, but also to describe in more positive terms the types of practices to be followed. It is not sufficient to indicate the restrictions on the extent of investment to be made in a single company, if the investment manager in fact intends to diversify more than would be required by that restriction and does not propose to make full use of his powers to invest in single companies. If the power to make such investments is retained for use in unusual situations, the statement of investment practices should indicate that the power will rarely be used to its full extent.

12.98 The changes advocated in preceding paragraphs cannot be enforced by precise regulations; they can result only from consultations between the appropriate administrators and those responsible for the preparation of statements of investment objectives and practices. Closely related to these changes is the succinct summary of the statement of investment objectives and of the major aspects of the statement of investment practices which would be included in the summary prospectus proposed in paragraphs 14.57 to 14.59. The summary of investment objectives and practices should be prepared in conjunction with the full statements, so as to reflect the conclusions in preceding paragraphs, and should be included in the annual report of the mutual fund as well as in the summary prospectus.

12.99 It is apparent from the discussion in this section and throughout this chapter that we attach considerable importance to statements of investment objectives and practices. Amendments to these statements are of considerable significance to shareholders or unitholders. We have concluded that no amendment to such a statement, either of objectives or of practices, should be permitted without prior consent of shareholders or unitholders obtained in accordance with the procedures enacted pursuant to paragraph 6.57. The only exception to this requirement would be cases where the appropriate admistrator ruled that the proposed amendment was in the best interests of all shareholders or unitholders, or was immaterial to them.

12.100 For the reasons set out in this section, we recommend:

(1) that in his review of statements of investment objectives and practices of mutual funds, the administrator should press for:

(a) more precise statements of investment objectives than are presently adopted for most Canadian mutual funds, with particular reference to the extent to which risks will be accepted in the quest for superior rate of return;

(b) closer relationships between the statement of investment objectives and the statement of investment practices, so that the latter will more accurately reflect the types of trading actually to be used in the attempt to carry out the investment objectives; and

(c) the inclusion in statements of investment practices of indications of the practices intended to be pursued, as well as of restrictions on the kind of practices that may be pursued;

(2) that the summary statement of investment objectives and practices to be included in the summary prospectus proposed in paragraph 14.61, recommendation (2), should be prepared in conjunction with the full statements and should reflect the recommendations in recommendation (1);

(3) that the annual report of a mutual fund should include a copy of the summary statement of investment objectives and practices referred to in recommendation (2) and should be permitted to include the full statement of investment objectives and practices; and

(4) that no amendment should be made to the statement of investment objectives and practices without the approval of shareholders or unitholders in accordance with paragraph 6.59, recommendation (3); provided that the appropriate administrator should have power to waive the requirement upon being satisfied either:

(a) that the proposed amendment was in the best interests of all shareholders or unitholders; or

(b) that the proposed amendment was immaterial to shareholders or unitholders.

CHAPTER XIII

ISSUANCE AND REDEMPTION OF SHARES AND UNITS

13.01 Redeemability at the option of the holder is important as the characteristic which distinguishes the mutual fund share or unit from all other equity instruments. It is also one of the most significant features of the mutual fund industry from a regulatory viewpoint. Combined with the continuous distribution of shares or units in which most mutual funds engage, it gives rise to many of the problems considered in this report. It would be surprising were this not the case, for these characteristics constitute not only a technical distinction but a fundamental difference between mutual funds and other organizations which issue equity participations to the public.

13.02 Shares of a public company other than a mutual fund are traded in the public market at prices determined principally by supply and demand. Many factors contribute to the supply and demand; the net value of the assets is important, but is not the only factor of importance. The shares of a public company with good management, or which is active in an expanding area of the economy, or which has a favourable debt structure, may command a higher market price than those of another public company with net assets of equal value and with the same number of shares outstanding. The extent of availability of the stock may also influence its price. All of these factors affect the prices at which shares issued by closed-end investment companies are traded. Yet the method of operation of mutual funds is such as to exclude these factors; the price on issuance and redemption of shares or units is, except for sales charges and redemption fees, computed entirely by reference to the proportionate value

of the interest they represent in the mutual fund portfolio. The exception is of considerable importance; sales charges often substantially increase the purchase price and redemption fees may decrease the amount payable on redemption. They are, however, received by the distribution company rather than the mutual fund, and are therefore not considered here. Chapter X includes a discussion of sales charges and redemption fees.

13.03 While it is obviously of great importance to devise a formula which will permit a precise computation of price for mutual fund shares or units, it is apparent that no formula can be relied upon to result in the same price which would be produced if mutual funds were listed in the public market and were therefore subject to the operation of the law of supply and demand. In the case of most mutual funds, which continuously issue as well as continuously redeem their shares or units, both supply and demand are, in effect, unlimited. Nor is it possible to make allowance in the computation formula for such intangible factors as the quality of management, to which weight would be given in a public trading market. Only one factor can in practice be given weight: the value of assets in the portfolio less outstanding liabilities, or net asset value, which can be expressed on a per share or unit basis through division by the number of shares or units outstanding. Much of this chapter is devoted to problems in the determination of that figure.

13.04 While the differences between the methods used in price determination for mutual funds and those used in price determination for shares of publicly traded companies would in any event be dictated by the lack of a mechanism for the law of supply and demand to operate in the former context, those differences are representative of a more fundamental difference between the two types of security. This is that shares of most public companies represent a direct investment in a certain company or enterprise, involving an assessment of management, of long-range prospects and similar matters. Investment in a mutual fund, on the other hand, involves the delegation of investment management to the management company. As such, it is inherently a long-term decision to a far greater extent than is true with the purchase of shares in other public companies.

13.05 To treat mutual fund shares or units as a short-term investment is not only conceptually inappropriate, it can involve serious practical problems. When an investor wishes to purchase shares or units, his order is ordinarily satisfied through their issuance by the mutual fund; when he wishes to sell shares or units, his order is ordinarily satisfied through their redemption by the mutual fund. Short-term transactions can have a serious effect on cash flow and thereby complicate the management of the mutual fund portfolio. In addition, the mutual fund ordinarily absorbs the brokerage and other costs attendant upon the purchase of securities to invest money received for shares or units sold, and similar costs attendant on the sale of securities which may be necessary to pay the redemption price of shares or units redeemed. This arrangement can be abused by the short-term holder, who can use the mutual fund as a method to obtain a short-term participation in a portfolio of securities without payment of brokerage. Such abuses are most likely to occur with transactions of a size sufficient to receive the benefit of the volume discounts discussed in paragraphs 2.18 to 2.20, or with transactions in mutual fund shares or units that are sold without sales charges.

13.06 For the reasons indicated above, a number of the recommendations in this chapter are designed to discourage the purchase of mutual fund shares or units on a short-term basis. It should be emphasized that this objective is in no way inconsistent with the pursuit of a short-term trading policy by the mutual fund itself, if such a policy is consistent with its statement of investment objectives and practices. If the investor wishes to have his money managed on the basis of short-term trading, he should be able to select a mutual fund with that type of trading policy. The point is that once he has selected the mutual fund, he should regard his own investment in it as a long-term commitment.

13.07 In this chapter we consider first the method used to value mutual fund shares or units. For convenience, the letters "N.A.V.P.S." are used to mean net asset value per share or unit, or the value of the proportionate part in the portfolio of a mutual fund represented by one of its shares or units. The amount paid for shares or units purchased can be computed by adding sales

charges to N.A.V.P.S., and the amount received for shares or units redeemed can be computed by deducting redemption fees from N.A.V.P.S. After the consideration of valuation we discuss when it should be computed with respect to any purchase or sale. We then consider the problem of the short-term purchaser, dealing first with the development of secondary markets in shares or units, and then with the large volume, short-term purchaser. Finally, we consider the extent to which it should be permissible to pay for shares or units issued or redeemed in securities rather than in cash, and the circumstances in which mutual funds should be permitted to suspend the right of redemption.

Computation of N.A.V.P.S.: Generally Applicable Considerations

13.08 While the computation of N.A.V.P.S. involves a number of problems, the method followed can be easily described. Three figures are determined: total value of assets in dollars; total value of liabilities in dollars; and total number of shares or units outstanding. Liabilities are deducted from assets and the result divided by the number of shares or units. The resultant figure is the N.A.V.P.S. With most Canadian mutual funds this figure represents the price charged for each share or unit issued and paid for each share or unit redeemed; it usually does not correspond with the prices quoted to the public, for the distribution company usually adds a sales charge and sometimes deducts a redemption fee. The bid price quoted in the press and elsewhere equals N.A.V.P.S., less a redemption fee where applicable. The asked price equals N.A.V.P.S., usually plus a sales charge. Our concern in this chapter is exclusively with prices paid and received by the mutual fund itself so that we do not here discuss sales charges and redemption fees. Subject to the comments made in the next section and elsewhere in the remainder of this chapter, we accept the three-figure formula described above as the method for computation of N.A.V.P.S.

13.09 In the next section, we consider the arguments which favour an adjustment in the computation of N.A.V.P.S. in addition to the three-figure formula. We then discuss the most difficult to determine of the three figures, the total value of assets of the mutual fund. The problems which relate to the determination of this figure but not to the other two figures are

first discussed. Other problems, which affect the determination of the amount of liabilities and of the number of shares or units outstanding as well as the value of assets, are considered in paragraphs 13.45 to 13.57.

13.10 The objective of the suggestions made in the following discussion is to attain fairness for all concerned in the pricing procedure. If N.A.V.P.S. is higher than it should be, the purchasing shareholder or unitholder will suffer; if it is lower than it should be, the redeeming shareholder or unitholder will suffer. The objective in the valuation of a mutual fund portfolio to compute N.A.V.P.S. should, therefore, be complete precision. This is not always true with security valuations for other purposes, since it is frequently appropriate in view of the purpose for which a valuation is made to resolve difficult questions through the acceptance of a value known to be not greater than the true value. This has resulted in the oft-used "lower of cost or market" approach to the valuation of securities, an approach which would be inappropriate in the context of mutual funds.

13.11 Another consideration which is important to the conclusions reached in the following sections is that the computation of N.A.V.P.S. is done in the context of the mutual fund as a continuing operation. It might be said in theory that the N.A.V.P.S. should be so computed as to result in a price at which any number of shares or units could be bought or any number of shares or units could be sold, without affecting N.A.V.P.S. Such a theoretically perfect valuation would be impossible for any of a number of reasons considered in the following sections. It is, however, feasible to arrive at an N.A.V.P.S. figure which can be used with fairness in practice. This is because the valuation treats the mutual fund as a continuing enterprise, rather than an organization about to be liquidated or to experience a major proportionate increase in size. Redemptions and purchases during a short period are rarely large in proportion to total net assets, and therefore any inequity is very small when considered on a per share or unit basis. In addition, redemptions are usually satisfied from the proceeds of sales with a consequent further reduction in the potential impact of a failure to attain theoretical perfection in the computation of N.A.V.P.S.

13.12 In spite of the fact that it may be impossible to support a particular procedure or technique in portfolio valuations as the only correct one, it is important that consistency be maintained in the methods used for N.A.V.P.S. computation in a particular mutual fund. For example, practices differ as to whether valuations should be made on the basis of bid price, asked price, or last sale price of the securities held in the portfolio of the mutual fund. While we make no recommendation on this question, so that flexibility will be available for the procedure to be adopted which is most appropriate to the assets held by a particular mutual fund, it is important that a rule be adopted and adhered to. To make use of bid prices on one day and asked prices on the following day would result in an artificial increase (or would artificially reduce a decrease) in N.A.V.P.S. and as a result would provide a benefit to some participants while operating to the detriment of others. So long as the same rules are consistently followed and provided that the rules are themselves reasonable, no such artificial benefit or detriment should occur.

13.13 As the preceding paragraphs indicate, we recognize that a number of problems are involved in N.A.V.P.S. computation. We have considered all these problems, and have concluded that none of them is sufficient to deny the validity of the general principles presently applied in such computations. This conclusion is premised on the assumption that the specific recommendations made in following sections will be implemented and on the further assumption that the organization with responsibility for making the computation will do so in good faith and in the best interests of all concerned. The latter assumption is of particular importance because it is impossible to formulate precise procedures which will adequately resolve all the problems in N.A.V.P.S. computation, particularly with respect to valuation. The entire computation procedure is an important topic to be considered by the auditor and by the appropriate administrator in the reviews proposed in paragraphs 8.65 to 8.76.

13.14 For the reasons set out in this section, we recommend:

(1) that, subject to the recommendations made in following sections, the general practice followed in the computation of the value of the portion of a mutual fund portfolio represented by a single share or unit

(referred to in this paragraph and in the recommendations made in the following sections as "N.A.V.P.S.") should continue to be followed. That practice is to determine the total value of assets in dollars; to deduct the total value of liabilities in dollars; and to divide the result by the total number of shares or units outstanding; and

(2) that the inspections contemplated by the recommendations in paragraph 8.78 should include reviews of procedures followed in the computation of N.A.V.P.S. of mutual funds.

Variations in the Formula for N.A.V.P.S. Determination

13.15 The formula for the determination of N.A.V.P.S. set out in paragraph 13.08 assumes that a single price can be determined at which shares or units can be issued and redeemed without unfairness to any party involved. It can be contended that such a determination is impossible to make, and that the price received by the mutual fund for shares or units issued should be higher than that paid by it for shares or units redeemed. Two principal arguments support this contention. The first is based on the fact that N.A.V.P.S. represents a dollar valuation of an interest in a portfolio of securities, and that there are brokerage and other costs involved in investing money received for shares or units issued, or in liquidating securities to pay for shares or units redeemed. The argument is that these costs should be reflected in a spread between sale and redemption prices charged or paid by the mutual fund.

13.16 The second argument supporting different prices for sales and redemptions is based on the fact that market prices of securities are traditionally quoted as "bid" and "asked" prices, meant respectively as the price for which a security can be sold and the price at which it can be purchased. The latter is, of course, always higher than the former. Determination of the value of a portfolio on the basis of market asked prices may produce a result as much as 1% higher than would follow if the same portfolio were valued at market bid prices. The difference can be even greater with a portfolio invested heavily in securities in which the trading volume is low; with such securities the spread, or difference between asked and bid prices, tends to be

comparatively large. The argument, then, is that this difference between bid and asked prices should be reflected in portfolio valuation so that the amount received for shares or units issued will be determined by the asked price of portfolio securities, and the amount paid for shares or units redeemed will be determined by the bid price of portfolio securities.

13.17 The organizers of a few Canadian mutual funds have accepted the two arguments set out above. Two examples are sufficient. In the case of Phillips, Hager and North Trust, N.A.V.P.S. is first computed in accordance with the three-figure formula described in paragraph 13.08. The resultant figure is increased by 1% to determine what should be received for each unit issued, and decreased by 1% to determine what should be paid for each unit redeemed. The second example, The Incubation Group Limited, is a mutual fund whose investment objective is to invest in small companies, referred to in the statement of investment objectives as being in their "incubation" stage. It is one of the very few Canadian mutual funds that acts as its own distribution company. The prices charged by it on sales of shares and paid by it on redemptions are therefore the same as those available to the public. The following quotations from its prospectus indicate the manner of computation of sale and redemption prices:

> The offering price of the Redeemable Shares is the amount obtained by dividing the "total net assets of the Fund valued for offering purposes" by the number of Redeemable Shares and Common Shares outstanding at the time of determination. The "total net assets of the Fund valued for offering purposes" is the excess of the gross assets of the Fund over the gross liabilities of the Fund and for this purpose gross assets include securities valued at replacement cost (ordinarily based on the last sale price for listed securities and on last bona fide asking price for securities valued on over-the-counter markets) and incorporation, promotion and organization costs and costs of a like nature. The offering price of the Redeemable Shares (exclusive of any sales commission) cannot be less than the par value of the Redeemable Shares.
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> The redemption price of the Redeemable Shares is the amount obtained by dividing the "total net assets of the Fund valued for redemption purposes" by the number of Redeemable Shares and Common Shares outstanding at the time of determination. The "total net assets of the Fund valued for redemption purposes" is the excess of the gross assets of the Fund over the gross liabilities of the Fund and for this purpose gross assets include securities valued at the amount that would be realized if sold (ordinarily based on last sale price for listed securities and last bona fide bid price for securities valued on over-the-counter markets) but no amount for incorporation, promotion and organization costs and costs of a like nature is included.

It is apparent from these quotations that the two prices are meant to reflect the arguments in the two preceding paragraphs, although the decision to adopt the two-price system may have been influenced as well by the fact that The Incubation Group Limited pays a commission on the sale of its shares or units.

13.18 The arguments supporting a spread between the sale and redemption prices charged or paid by mutual funds have been accepted by the Board of Trade in England, which requires that the offering price for units of unit trusts (the English equivalent of mutual funds) be so computed as to reflect the foreseeable costs involved in investment of the proceeds of sale, and that the redemption price reflect the cost of liquidation of securities to raise money for the redemption. The portfolio must be valued both at market asked and at market bid prices, and adjustments made for brokerage costs, taxes, and other expenses.* The Securities and Exchange Commission in the United States does not impose any similar requirement on mutual funds in that country.

13.19 While the arguments in favour of different prices for the issuance and redemption of mutual fund shares or units are logical ones, we have concluded that this pricing system should not be required for Canadian mutual funds. One reason for this conclusion is that it is in fact rarely necessary to liquidate securities in order to meet requests for redemption, and often not necessary to pay brokerage expenses in order to invest newly received cash. This is supported by the data in Appendix "B", which indicate that in almost all periods the proceeds of sales of mutual fund shares or units exceed the amount required to pay for redemptions. Mutual funds are thereby enabled to maintain a cash float which is almost invariably sufficient to effect payment for shares or units redeemed. Large redemptions that might necessitate the liquidation of securities would usually be covered by our proposals in paragraphs 13.89 to 13.100 specifying circumstances in which mutual funds should be permitted to deliver portfolio securities rather than cash in satisfaction of requests for redemption.

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* Prevention of Fraud (Investments) Act, 1958 (6 & 7 Eliz.2 C.45), S. 17 (1)(C), First Schedule, and more specifically, requirements under the First Schedule of this Act.

13.20 Another objection to the compulsory adoption of a two-price system is that it would imply a degree of precision in valuation procedures which is simply not present. As noted in paragraph 13.12, practice varies between mutual funds as to whether bid, asked, or last sale price is the appropriate valuation for publicly traded securities. Regardless of which is selected, there cannot be certainty that a sale or purchase in excess of a single board lot could be effected at that price. Given the lack of precision in valuation which results from this fact, it would be unrealistic to require that a minor adjustment in price be made to reflect brokerage costs.

13.21 Another relevant fact is that any unfairness which results from use of a single N.A.V.P.S. for issuance and redemption would be of benefit principally to the short-term speculator. An investor who holds his mutual fund shares or units over a long term will almost certainly neither benefit nor suffer as a result of the single price system; he may receive a theoretical advantage at the time of purchase and again at the time of redemption, but this will be minimized or eliminated by purchases and redemptions effected by others during the intervening period. The short-term holder, on the other hand, receives the same advantage at the time of purchase and of redemption, and does not suffer to the same extent as the long-term holder from intervening purchases and redemptions. As stated in paragraph 13.05, we regard the mutual fund as an inappropriate vehicle for short-term investments, and in this chapter we make a number of suggestions designed to discourage short-term investors. Implementation of those suggestions would result in a substantial decrease in the number of purchasers who derive a material benefit from the single price system.

13.22 Our conclusion that two-price systems for the issuance and redemption of shares or units by mutual funds should not be required is not intended to imply that they should be prohibited. Organizers of a mutual fund, particularly one which is to carry on a distinctive type of investment activity with high initial costs, may well wish to establish a two-price system; The Incubation Group Limited, referred to in paragraph 13.17, is a good example. We have, however, concluded that the only adequate justifications for a two-

price system are the two arguments set out in paragraphs 13.15 and 13.16, being the brokerage and other costs required to effect or to liquidate investments and the spread between bid and asked prices in the quotations of portfolio securities. Accordingly, any two-price system should be so designed as to reflect one or both of these factors, and the appropriate administrator should be given authority to reject any proposed two-price system that would result in a price differential not justified by these factors.

13.23 The conclusion expressed in the preceding paragraph assumes that the amount paid for shares or units purchased will be applied for the benefit of the mutual fund, and we regard this assumption as one which the purchaser is justified in making. In addition, it is desirable to encourage uniformity in procedures followed on the purchase and redemption of shares or units. For these reasons, we concluded that a mutual fund should be prohibited from the payment of any commission on the sale of its own shares or units; the commission or sales charge should take the form of an amount, disclosed as such, which is paid by the purchaser in excess of the amount received by the mutual fund. Another argument in favour of this conclusion is that to permit payment by the mutual fund of such commissions would require all the shareholders or unitholders to contribute to the commission payable for each new share or unit. If a mutual fund with total net assets of $10,000 and 100 shares or units outstanding sells an additional share or unit for $100 and pays a $9 commission, the purchaser of the new share or unit will bear only 1/101 of the commission payment, or less than 9¢, while he would ordinarily be required to pay the full $9.00. We do not criticize the few Canadian mutual funds which presently engage in this practice, but we have concluded that they should be required to cease doing so.

13.24 As indicated in the introductory portion of this chapter, we are concerned here primarily with the amount received or paid by the mutual fund for shares or units issued or redeemed by it. The importance of the distinction between charges or fees received by the mutual fund and those received by the distribution company is obvious. The former do, and the latter do not, benefit mutual fund participants. We have reviewed a few prospectuses from

which it is impossible to determine whether certain payments, particularly for redemption fees, are made to the mutual fund or to the distribution company. We think it important that this disclosure be clearly made in all cases.

13.25 For the reasons set out in this section, we recommend:

(1) that mutual funds should not be required, but should be permitted, to charge a price for shares or units issued which differs from that simultaneously in effect for shares or units redeemed; provided that the difference between the two prices should not exceed what is justified by one or both of the following factors:

(a) the brokerage and other costs involved in the investment of money received on the sale of shares or units and the liquidation of investments to pay for the redemption of shares or units; and

(b) the difference between N.A.V.P.S. computed on the basis of bid prices of portfolio securities, and that computed on the basis of asked prices;

(2) that mutual funds should not be permitted to pay any commission on the sale of their shares or units; and

(3) that mutual fund prospectuses should clearly indicate whether sales charges, redemption fees and similar payments enure to the benefit of the mutual fund and, if not, to whose benefit they do enure.

Valuation of Mutual Fund Assets

13.26 Of the three figures which must be determined in order to compute N.A.V.P.S., the value of the assets of the mutual fund presents the most difficult problems. This is because, for a number of reasons discussed in this section, an exact expression in dollars of the value of an interest in a portfolio of investments can only be arrived at on the basis of certain assumptions. The most important assumption, alluded to in paragraph 13.11, is that the mutual fund can be treated as a continuing operation for purposes of valuation. The value sought is not what would be realized on a liquidation; nor is it the cost of duplicating the portfolio; rather, it is a reasonable price on the basis of which shares or units can be sold or redeemed assuming

that the mutual fund will not experience a major increase or decrease in total net assets through sales or redemptions effected at that price. If this assumption could not be made, extensive revisions would be required in currently prevailing valuation practices, and it might well be necessary to abandon the use of a single N.A.V.P.S. for purchases and redemptions.

13.27 We reproduce in a footnote an extract from the prospectus of an incorporated mutual fund which sets out the valuation rules adhered to in the computation of N.A.V.P.S. for that mutual fund.* This quotation is representative of prevailing practice in the Canadian mutual fund industry, although

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* The assets of the Company shall be deemed to include (a) all cash on hand or on deposit, including any interest accrued thereon, (b) all bills and demand notes and accounts receivable, (c) all bonds, time notes, shares, subscription rights and other securities owned or contracted for by the Company, (d) all shares and cash dividends and cash distributions to be received by the Company and not yet received by it when the asset value is being determined as of the record date (or the ex-dividend date if different from the record date) or a date subsequent thereto, (e) all interest accrued on any interest-bearing securities owned by the Company (except interest accrued on securities in default which is included in the quoted price) and (f) all other property of every kind and nature including prepaid expenses; the value of such assets to be determined as follows:

I The value of any cash on hand or on deposit, bills and demand notes and accounts receivable, prepaid expenses, cash dividends and interest declared or accrued as aforesaid and not yet received shall be deemed to be the full amount thereof unless the board of directors shall have determined that any such deposit, bill, demand note or account receivable is not worth the full amount thereof, in which event the value thereof shall be deemed to be such value as the board of directors shall deem to be the reasonable value thereof;

II The value of any bond, time note, share, subscription right or other security which is listed or dealt in upon a recognized stock exchange shall be determined by taking the latest available sale price (or lacking any sales or any record thereof a price not higher than the latest available asked price and not lower than the latest available bid price therefor as the board of directors may from time to time determine) on the day as of which the asset value is being determined or, if such recognized stock exchange is not open on that day, then on the most recent day on which such recognized stock exchange was open, all as reported by any means in common use; the value of interlisted securities shall be computed in accordance with directions laid down from time to time by resolution of the board of directors, provided, however, that securities listed on The Toronto Stock Exchange shall be valued at prices on that Exchange and provided further that the board of directors may by a resolution permit over-the-counter rather than stock exchange quotations to be used when they appear to the board of directors to reflect more closely the fair value of any particular security in the portfolio; and provided further that if, in the opinion of the directors, stock exchange or over-the-counter quotations do not properly reflect the prices which would be received by the Company upon the disposal of shares or securities necessary to effect any redemption or redemptions, the board of directors may by resolution place such value upon such shares or securities as appears to the board to most closely reflect the fair value of such shares or securities.

there are many differences of detail among mutual funds. It will be noted that the rules contained in the quotation rely principally on price quotations established by market trading, where such quotations are available, but that the board of directors has discretion whether to accept these price quotations; the board of directors is also given wide discretion in cases where price quotations established by market trading are not available.

13.28 We recognize that it is important for the person or organization responsible for the valuation, whether it be the board of directors or the management company, to have discretionary authority in order to deal with unusual problems. On the other hand, it is of even greater importance for the rules which are applied in the usual case to be articulated. The provisions contained in the footnote to the preceding paragraph provide a good example of rules designed to deal with the usual case, the valuation of securities for which price quotations established by market trading are readily available. They specify that such price quotations will be used in the ordinary case, but subject to an overriding discretion in those responsible for the valuation to enable them to deal with unusual problems.

13.29 The rules set out in the footnote to paragraph 13.27 are, in our opinion, not as satisfactory with respect to investments for which market quotations are unavailable. In particular, undue reliance is placed on discretionary decisions in category IV, investments for which there is no price quotation established by market trading or otherwise. In paragraphs 13.40 to 13.43 we make proposals designed to result in greater precision in the statements of rules for valuation of this type of investment.

III The value of any bond, time note, share, subscription right or other security which is not listed or dealt in on a recognized stock exchange shall be determined on the basis of such price quotations as the board of directors determines best reflects its fair value; and

IV In the case of any bond, time note, share, subscription right, other security or other property for which no price quotations are available as above provided, the fair value thereof shall be determined from time to time in such manner as the board of directors from time to time by a resolution provides;

13.30 The reliance on price quotations established by trading in the public markets which is exemplified by the provision in the footnote to paragraph 13.27 is representative of the general principles in the computation of N.A.V.P.S. of which we indicate our acceptance in paragraph 13.13. No other method is available to provide precise valuations of securities on a basis equally fair for all concerned. It cannot, however, be said that market values provide a perfect solution to problems of valuation. Particularly in view of the importance of valuation procedures to the mutual fund industry, it is desirable to review and to assess the significance of the difficulties in the use of market price quotations.

13.31 The principal problems with the use of market prices arise from the fact that the securities markets do not, and cannot, provide perfect liquidity at quoted prices. Technically, a bid price means only that, at the time the price was established, at least one board lot of the security could be sold at that price. In practice it is usually of greater significance, particularly as the stock exchanges improve their procedures to prevent rapid fluctuations in prices of securities. In most cases it is reasonable to assume that a relatively substantial block of securities can be sold at or near the bid price. Only rarely would a mutual fund be able to sell its entire holding in a security at that price; this does not prevent the use of the price for valuation purposes since it is not necessary to compute N.A.V.P.S. as a liquidation figure.

13.32 While perfect liquidity of the market is not a necessary precondition to reliance on it for purposes of valuation, in some cases the market in a particular security is so illiquid that the quoted prices have little or no real meaning. This is particularly true in Canada, where the "thinness" of the securities market is sometimes a serious problem. The difficulties in valuation of securities under these circumstances are accentuated when the mutual fund concerned has a substantial holding in the securities being valued. Not only does the size of the holding make the application of market price to determine its total value less realistic, but the holding can artificially

increase the market price through a reduction in the available supply of securities to satisfy demand.

13.33 The problems involved in the valuation of securities in which the public trading market lacks adequate liquidity have become increasingly important with the growth in size of the mutual fund industry and with the growth in emphasis on performance in the sense of rate of return. The former means that more money is available for investment, and therefore that positions in individual issues have tended to become larger. The latter has resulted in greater emphasis on securities issued by comparatively small companies with high growth potential, particularly those which capitalize on technological innovation. Such companies, which were often ignored by institutional investors until the advent of the emphasis on performance, have made a substantial contribution to the high rates of return produced by a number of mutual funds. The difficulty is that the public trading market in securities of many of them presents in an acute form the problems discussed in preceding paragraphs.

13.34 An important example of the emphasis on securities of smaller companies has been participation by mutual funds in private placements of such securities. These are distributions of securities that would ordinarily be regarded as primary distributions requiring the filing of prospectuses, but which are exempted from the prospectus requirements by special provisions commonly referred to as the private placement exemptions. Mutual funds have long participated in private placements made by established companies selling further issues of their securities. Their more recent tendency to participate in private placements of small companies without established records has been a source of concern to regulatory authorities. This is particularly true since the price at which such purchases are effected is frequently below the prevailing market price in previously issued securities of the same class. The practice in Canada is to value the newly purchased securities at current market value for purposes of N.A.V.P.S. determination, so that in cases where the price paid is less than market price an instantaneous profit results.

13.35 It is usually a condition of private placements that the purchasers acquire the securities for investment and not for resale. While it may be that this is not invariably a requirement of law, in an increasing percentage of private placements the purchasers supply the vendor with "investment letters" attesting to the satisfaction of this condition. The content of these letters is discussed in paragraph 12.26, where we note that the term "letter stock" is frequently used for the securities with respect to which such letters are given. In the United States similar letters are given in the same circumstances and their significance has become comparatively clear through regulation and practice. It is clear in that country that the disposability of letter stock is severely restricted. Partly because the consequences of investment letters are comparatively clear and partly as a result of suggestions made by the Securities and Exchange Commission, letter stock is usually valued at less than the prevailing market price; one rule frequently applied is that until the effect of the investment letter has terminated, the letter stock should be valued at the same discount from current market price that its purchase price represented at the time of purchase.

13.36 In paragraph 12.27 we distinguish between investment letters which merely attest that the purchase is for investment, and those which prohibit resale without consent of the original seller. We conclude that purchases of securities subject to the latter type of investment letter should be prohibited for mutual funds. In spite of recent steps by Canadian regulatory authorities towards the enunciation of more precise rules to govern private placements, the effect of the former type of an investment letter in Canada remains unclear at the time of writing. It is clear that the investment restriction constitutes a restriction on transferability, but the extent of that restriction has not been defined. Our impression is that many purchasers give little weight to the representations contained in investment letters.

13.37 We do not think the present uncertainty in the law relating to letter stock will long continue; the effect of investment representations will be given increasing attention in coming years, and Canadian law and practice will eventually determine the legal relevance of an investment letter.

Because that determination has not been finally made, we do not propose that the valuation of securities purchased in private placements should be required to be made on a basis different from that used for other securities. As soon as the determination is made, appropriate changes should be made in the methods of valuation of securities which are subject to investment letters in order to reflect the resultant restrictions on their transferability. The method used in the United States and described in paragraph 13.35 may be appropriate for this purpose.

13.38 The conclusion that until the law concerning the consequences of investment letters becomes clear, it should be permissible to value letter stock in the same way as other securities of the same class leaves open the general question whether special provisions should be made for the valuation of securities in which the trading market is limited. While such provisions might be desirable, we have been unable to evolve an alternative rule or procedure which would result in a more accurate indication of value. Therefore, while discretion should be retained so that the organization which makes the valuation can effect appropriate adjustments in special cases, we have concluded that the practice of relying on market price should not be restricted.

13.39 Our acceptance of the prevailing practice in valuation of publicly traded securities does not represent a conclusion that this practice should be embodied in regulations. Provided that consistency is maintained in the procedures followed for the computation of N.A.V.P.S. of a mutual fund, we think that variations in those procedures may be beneficial. It is clear that the existing valuation systems are not completely satisfactory, and to perpetuate them by regulation might prevent desirable innovations. Instead, the appropriate administrator should review the rules adopted by mutual funds in order to verify that they are reasonable, and are consistently applied.

13.40 Different problems arise with the valuation of investments which are not publicly traded or for which a valuation cannot readily be established in other ways. Such investments would fall within the definition of illiquid investments proposed in paragraphs 12.14 to 12.28, and the importance of valuation techniques used for them would be accentuated by implementation of

the recommendations in Chapter XII under which both conventional and non-conventional funds would be permitted to invest significant portions of their assets in illiquid investments. Most sets of valuation rules used by Canadian mutual funds contain provisions for illiquid investments substantially similar to those in category IV in the footnote to paragraph 13.27. We have concluded that more detailed provisions are desirable. The investment objectives of a mutual fund should include a statement of the types of illiquid investments to be acquired by it, and the valuation rules should prescribe how each type is to be valued.

13.41 The appropriate administrator in his review of valuation rules will be expected to consider the rules applicable to illiquid investments. This will be an important activity for administrators, and one in which they have not previously been engaged to the same extent. It would be desirable for arrangements to be made whereby they may call on professional valuators for advice on the adequacy of proposed valuation techniques.

13.42 In the valuation of illiquid investments, as of publicly traded securities, discretion should be reserved for the organization responsible for the valuation to deviate from the prescribed rules in unusual cases. This can be an important discretion, and we have concluded that the appropriate administrator should be able to verify that it is properly exercised. For this purpose, the organization which performs the valuation should retain a written record of each case in which it has deviated from the rules prescribed in its prospectus or other relevant document for the valuation of investments. This record should be available for inspection by the mutual fund auditor or the appropriate administrator at any time.

13.43 The conclusions reached in preceding paragraphs would allow for considerable flexibility in the formulation of rules to be followed in the valuation of mutual fund investments. Such flexibility is desirable, but we have concluded that circumstances could arise in which the application of uniform rules on an industry-wide basis would be even more desirable. The relevant legislation should therefore reserve authority for the passage by regulation of rules concerning the valuation of mutual fund investments for purposes of the computation of N.A.V.P.S.

13.44 For the reasons set out in this section, we recommend:

(1) that, as soon as the effect under relevant legislation in Canada of an investment letter or investment representation given by the purchaser of securities in a private placement has become clear, appropriate adjustments should be made in the methods used to value such securities to compute N.A.V.P.S.;

(2) that the rules to be applied in the valuation of investments of a mutual fund should not, at least initially, be fixed by regulation, but that such rules should be formulated by each mutual fund organization and should contain precise provisions applicable to the usual case, subject to an overriding discretion in those responsible for the valuation to enable them to deal with the unusual case;

(3) that the investment objectives of a mutual fund should include a statement of the types of illiquid investments which it may purchase, and the rules referred to in recommendation (2) should indicate how each such type is to be valued;

(4) that the appropriate administrator should review the rules as to valuation to be followed by a mutual fund in order to verify their adequacy and fairness; arrangements should be made to permit the administrator to call on professional valuators for advice concerning rules of the type proposed in recommendation (3);

(5) that each organization responsible for making valuations should maintain a written record of the instances in which it exercises its discretionary authority to deviate from the prescribed valuation rules, and such record should be available for inspection by the mutual fund auditor or the appropriate administrator at any time; and

(6) that the relevant legislation should provide for the passage by regulation of generally applicable valuation requirements.

Transactions to be Reflected in Computation of N.A.V.P.S.

13.45 The discussion of valuation procedures in the preceding section includes a number of references to the fact that the mutual fund is a continuing operation, and should be treated as such in the computation of N.A.V.P.S. That fact avoids difficulties which might otherwise arise in the valuation of investments, but it involves other difficulties both with the value of the portfolio and with the other two figures necessary for N.A.V.P.S. computation, total liabilities and total number of shares or units outstanding. The fact that a mutual fund is continuously engaged in the issuance and redemption of shares or units, and in the purchase and sale of portfolio securities, makes it necessary to decide what transactions should be taken into account in the determination of N.A.V.P.S. at a particular time.

13.46 It is apparent that even the most sophisticated procedures will not permit an instantaneous determination of N.A.V.P.S. which will reflect all transactions up to a particular time. Information as to shares or units purchased, or as to the price at which securities have been purchased or sold for the portfolio of the mutual fund, immediately prior to the determination will often be unavailable. A decision as to the transactions to be reflected in the determination involves an assessment of the relative importance of precision of determination and speed of publication of the N.A.V.P.S. figure. If precision is given greater emphasis, publication of the N.A.V.P.S. figure computed as at a particular time should be postponed until full information is available concerning all transactions effected prior to that time. If speed of publication is given greater emphasis, it would be necessary to compute N.A.V.P.S. without such complete information. Each of these objectives is important, and they must be reconciled in the procedures adopted.

13.47 Transactions which might affect N.A.V.P.S. can be divided for analytical purposes into portfolio transactions, consisting of purchases and sales of investments by the mutual fund, and capital transactions, consisting of issues and redemptions of mutual fund shares or units. These two types of transactions are, of course, closely connected; capital transactions can increase or decrease available cash, thereby necessitating portfolio transactions

to adjust the cash reserve. It is apparent that both types of transactions can affect N.A.V.P.S., but it is important to note that the effect would rarely be instantaneous.

13.48 Portfolio transactions result in the exchange of investments for cash, or of cash for investments; with rare exceptions, such as the purchase of securities in private placements at less than their prevailing market price, the cash involved will equal the value of the investments. N.A.V.P.S. will therefore not ordinarily be materially affected by a portfolio transaction, be it a purchase or a sale, until a change occurs in the value of the investment concerned. If the cash and the investment remain of equal value, it will make no difference which is shown as part of the mutual fund portfolio for valuation purposes. Exactly the same is true of capital transactions; shares or units are issued or redeemed at N.A.V.P.S., and therefore subsequent N.A.V.P.S. computations will not be affected by the issuance or redemption so long as the other elements of the computation remain unchanged. A mutual fund with total net assets of $10,000 and 100 shares outstanding which issues ten additional shares for $1,000 will continue to have an N.A.V.P.S. of $100 whether it is computed as $10,000 divided by 100 or $11,000 divided by 110, but the two methods of computation will produce different results as soon as a change occurs in the value of the assets which make up the $10,000.

13.49 While the fact that neither portfolio transactions nor capital transactions ordinarily have an immediate effect on N.A.V.P.S. is important in a decision on the extent to which recent transactions may be omitted from N.A.V.P.S. computation, it is obviously desirable to attain the maximum precision of computation which is reasonably practicable. It is helpful in a consideration of this question to review the practical difficulties in obtaining current information on transactions, and the manner in which those difficulties ordinarily affect N.A.V.P.S. computation. This can conveniently be done through separate discussion of portfolio transactions and capital transactions.

13.50 A trade for the portfolio of a mutual fund is ordinarily effected pursuant to instructions telephoned by the investment manager to a broker. Almost invariably, the broker will telephone the investment manager following

completion of the transaction to furnish details of the security purchased and its price. On the same day the broker mails a formal confirmation of the transaction which is usually, but not always, received the next day. Procedures followed on its receipt differ between organizations. In many, it is checked by the investment manager and a copy initialled and sent to the custodian of the securities of the mutual fund. The custodian, who might not receive the confirmation for several days after execution of the transaction to which it relates, takes the steps necessary to implement the transaction, paying cash and receiving securities on a purchase and the reverse on a sale. This procedure, which would be consistent with the custodial procedures recommended in Chapter VIII, is workable because of the prevailing rule that settlement of securities transactions need not occur until the third trading day following their execution. It is apparent from this description that it would be difficult to maintain a continuously current record of portfolio transactions for N.A.V.P.S. computation. While some mutual funds rely on the telephoned confirmation from the broker for the necessary information, even they do not reflect most portfolio transactions in N.A.V.P.S. computations until the day after the transaction. Organizations which prefer to await the written confirmation experience even greater delays.

13.51 The difficulties described in the preceding paragraph are particularly serious in the case of mutual funds whose N.A.V.P.S. is computed daily. In these cases, the organizations concerned endeavour to compute N.A.V.P.S. on the basis of closing market quotations and yet to have the resultant figure available for publication in the evening newspapers. Only a few organizations, most of them small, reflect portfolio transactions effected during a particular day in that day's N.A.V.P.S. computation. A variety of procedures are followed in other cases. With at least one mutual fund, the portfolio is valued daily but the securities which are valued are those which made up the portfolio at the end of the preceding week, no matter how many trades have since occurred. The valuation made is, then, of the portfolio as it was constituted as much as a week prior to the date of determination. On the other hand, several of the larger mutual funds have procedures designed to enable all portfolio transactions to be reflected on the day following execution, and on the day of

execution if a substantial change in price occurs during that day. The practices followed in the determination of N.A.V.P.S. of other mutual funds for which N.A.V.P.S. is computed on a daily basis fall between these two extremes, with delays in recording transactions usually being less than a week but more than a day.

13.52 Under existing practices the elapsed time before a capital transaction is reflected in N.A.V.P.S. computation is, in some cases, longer than the corresponding period for a portfolio transaction. If, for example, an order is transmitted through an agent in the field, it can easily take several days to reach the central office of the mutual fund organization. Few organizations responsible for valuation of Canadian mutual funds have a specific rule as to the maximum time that may elapse between the date of a capital transaction and the date upon which it is reflected in N.A.V.P.S. computation. In some cases it is assumed that the sale or redemption does not in fact occur until the relevant information is entered on the books of the central office, and in these cases it could be contended that there is in fact no delay in reflecting the transactions in N.A.V.P.S. computation. Whatever the legal position as to the time of occurrence of the transaction it is clear that a delay of several days is not uncommon between the placing of an order and the date when it is first taken into account in the computation of total assets, liabilities or the number of shares or units outstanding.

13.53 In the formulation of rules to govern the procedures discussed in preceding paragraphs, certain conclusions reached in the next section should be taken into account. We there propose that no order for the purchase or redemption of mutual fund shares or units should be completed except at an N.A.V.P.S. determined as at a time after receipt of the order. This proposal is relevant to the present discussion because its implementation would to some extent reduce the importance of prompt publication of N.A.V.P.S. figures. If sales or redemptions are implemented at previously announced prices, a practice we refer to as "backward pricing", it is of great importance to effect prompt computation and publication of N.A.V.P.S. in order to reduce abuses of the type discussed in the next section. The same urgency is not present if the sale or

redemption is effected at a price determined as at a subsequent time, referred to as "forward pricing".

13.54 In spite of the considerations set out in the preceding paragraph, we recognize that mutual fund distribution companies would wish to arrange prompt computation and publication of N.A.V.P.S. figures whether the prevailing pricing system was backward pricing or forward pricing. This consideration is reflected in the proposals made below, which are designed to provide maximum flexibility consistent with adequate investor protection. We have concluded that the amount of permissible delay between the occurrence of a transaction and its reflection in N.A.V.P.S. computation is a topic concerning which regulations are necessary, for N.A.V.P.S. is of great importance in the mutual fund industry and if it is inaccurate unfairness will result.

13.55 We have concluded that each portfolio transaction should be required to be reflected in the computation of N.A.V.P.S. not later than the first such computation made after the date on which the transaction occurs; for this purpose, a transaction would be considered to occur on the date that it becomes binding, rather than the subsequent date of payment and delivery. Transactions effected on Monday for the portfolio of a mutual fund the N.A.V.P.S. of which was computed daily would be required to be reflected in the Tuesday computation. It would be necessary for the organizations concerned to institute procedures which would enable the relevant information on all portfolio transactions to be available sufficiently quickly for this rule to be complied with, or alternatively to decide not to compute the N.A.V.P.S. as at a certain time until the necessary information became available. This might mean, for example, that the Tuesday price would not be computed until Wednesday.

13.56 With respect to capital transactions, it is important that under our proposed forward pricing rule a sale or redemption of shares or units could not be immediately reflected in N.A.V.P.S. computation. It would be necessary to determine the price at which an order is implemented on the basis of a N.A.V.P.S. computation made as at a time subsequent to the order. This would mean that a capital transaction could not be reflected in N.A.V.P.S. computation until the first computation after the one which establishes the

price at which the order is implemented. We have concluded that such immediate reflection of a capital transaction in N.A.V.P.S. computation is not necessary, at least not for a mutual fund the N.A.V.P.S. of which is determined daily. Our suggested rule is that a capital transaction should be required to be reflected in N.A.V.P.S. computations made more than twenty-four hours after the time as at which the N.A.V.P.S. used to implement the transaction is computed. This rule would, in most cases where daily computations are used, permit the omission of a transaction from one N.A.V.P.S. computation in which it theoretically could be reflected. The same, would, under the rule proposed in the preceding paragraph, ordinarily be true of portfolio transactions.

13.57 The two rules proposed in the preceding paragraphs should be sufficient to ensure that any transaction likely to affect N.A.V.P.S. is reflected in its computation, except in unusual cases. An additional rule is appropriate to deal with the unusual cases. Where transactions known at the time of an N.A.V.P.S. computation would change the resultant figure by as much as a cent, and this fact is known or ought reasonably to be known to the persons responsible for the valuation, an appropriate adjustment should be required to be made in the resultant figure. Such a rule would be particularly valuable with respect to recently purchased or sold securities which experience a very rapid change in market price, and in cases such as those referred to in paragraph 13.34 where securities are purchased or sold at prices different from those applied in portfolio valuation.

13.58 For the reasons set out in this section, we recommend:

(1) that for purposes of the following recommendations, the term "portfolio transactions" should mean transactions of purchase or sale of investments effected by a mutual fund, and the term "capital transactions" should mean issues and redemptions by a mutual fund of its shares or units;

(2) that a portfolio transaction should be reflected in the computation of N.A.V.P.S. not later than the first such computation made after the date on which the transaction becomes binding;

(3) that a capital transaction should be reflected in computations of N.A.V.P.S. made more than twenty-four hours after the time as at which the N.A.V.P.S. applied to implement the transaction is computed; and

(4) that, where transactions known at the time of an N.A.V.P.S. computation would change the resultant N.A.V.P.S. by as much as a cent, and this fact is known or ought reasonably to be known to the responsible organization, an appropriate adjustment should be made in the resultant figure notwithstanding recommendations (2) and (3).

Relationship Between the Time of a Transaction and the Time of Computation of N.A.V.P.S.

13.59 Except in the theoretical case of a mutual fund with a portfolio which consists entirely of cash bearing no interest, the N.A.V.P.S. of a mutual fund fluctuates constantly with the value of and with the interest, dividends and other receipts earned by investments in its portfolio. In the preceding section we discuss the problems which arise from the fact that not all transactions which might affect N.A.V.P.S. can be instantaneously reflected in its computation. It is equally true that N.A.V.P.S. cannot be instantaneously computed for every sale and every redemption of shares or units; yet such instantaneous computation would be the only way to be certain that the amount received or paid by the mutual fund for the shares or units sold or redeemed exactly reflected N.A.V.P.S. at the time of each transaction. Because of the impossibility of attaining this degree of certainty, some compromise procedure must be followed which will be fair to all concerned and yet will be workable in practice. Two questions must be resolved in the formulation of this compromise procedure. The first is whether the price at which a particular transaction is effected should be determined by reference to N.A.V.P.S. computed prior to the transaction ("backward pricing") or subsequent to the transaction ("forward pricing"). The second question to be resolved is with what degree of frequency N.A.V.P.S. should be determined.

13.60 Until shortly prior to the time of writing, the prevalent practice of the majority of Canadian mutual funds, including almost all mutual funds the shares or units of which were sold subject to a basic sales charge

rate of 8.0% or more, was backward pricing. While details varied, the usual procedure followed by these mutual funds was for N.A.V.P.S. calculated at the close of the stock market on a particular day (i.e. calculated as of 3.30 p.m. and announced to the press by 4.30 p.m.) to be effective all of the following day and until 10.30 a.m. the next day. This meant that on Tuesday evening and until 10.30 on Wednesday morning two prices were known - the Monday closing price and the Tuesday closing price; and a purchaser could select the price at which his transaction would be effected. We are also aware of a number of cases in which, by special arrangement with a broker or independent sales force, a distribution company agreed to satisfy, at the N.A.V.P.S. computed on a particular day, all purchase orders received for up to a week thereafter.

13.61 On June 4, 1969 the Canadian Mutual Funds Association, at the instigation of the Ontario Securities Commission, adopted an amendment to its regulations to provide for current pricing; in its Bulletin of May, 1969, the Ontario Securities Commission required that other mutual funds in their next prospectus adopt either that ruling or the S.E.C. rule 22C-1 described in paragraph 13.66. The C.M.F.A. rule requires "current" pricing, which is backward pricing although each price becomes effective on determination; there is no period during which two prices are known. This rule reduces the potential abuses of the previous practice, for the purchaser who wishes to profit from the pricing procedure must estimate what price change has occurred since the preceding price. If the Monday N.A.V.P.S. is $9.70 and the stock market rises on Tuesday, a purchase may be effected prior to the close of the market on Tuesday, at the $9.70 N.A.V.P.S., on the assumption that the Tuesday N.A.V.P.S. will be higher.

13.62 The prevailing pricing procedure on redemptions differs from that on sales. In most cases, the price paid for shares or units redeemed is the N.A.V.P.S. computed either on the day of receipt of the order or on the following day; this procedure is confirmed by the C.M.F.A. rule referred to in the preceding paragraph. This means that until the C.M.F.A. rule becomes fully effective, which may not occur for some time after its introduction, backward pricing is the prevalent practice on sales, and forward pricing on redemptions.

In spite of the lack of availability of backward pricing on redemptions, these procedures leave open the possibility of abuse. In the situations described in the preceding paragraphs, the purchaser can affect a purchase at a price lower than the current N.A.V.P.S.; the effect of the new rule is to force him to estimate the current N.A.V.P.S., instead of having it computed for him, and also to reduce the time for which each price remains in effect. Under either procedure, the purchaser can immediately redeem the shares or units purchased, and thereby obtain an instant profit, subject only to the possibility that the closing price computed on the day of redemption might be less than the purchase price. Such a transaction constitutes an abuse; the "special arrangements" described in paragraph 13.60 constitute an even more serious abuse, although they would be prohibited under the C.M.F.A. rule.

13.63 The temptation to engage in short-term trading activities in order to make a profit through reliance on backward pricing is particularly strong for large investors who can afford to make purchases in sufficient size to take maximum advantage of the volume discounts described in paragraphs 2.18 to 2.20. Some distribution companies combat this practice by refusing any order which they know or believe to come from a purchaser who proposes to effect a short-term redemption, but it is often impossible to identify such an order. In some cases, the distribution companies do not discourage these transactions; the availability of a commission payment, even at very low rates, is a strong inducement. We have not conducted extensive research on the question, but we are aware of one mutual fund in which transactions of this type aggregated approximately $86 million during 1967. The size of these sales proportionate to the total volume of Canadian sales in that year is indicated by the statistics in paragraph 3.42.

13.64 The reasons for our belief that short-term transactions in mutual funds should be discouraged are set out in paragraphs 13.04 and 13.05 and will not be reviewed here. In paragraphs 13.80 to 13.86 we make proposals designed to penalize investors who engage in large volume transactions on a short-term basis. These would not completely resolve the potential abuses arising from backward pricing. Even purchasers who plan to hold for the long term often

take advantage of backward pricing so that they will have a paper profit at the outset of their investments.

13.65 We have concluded that the possibilities of abuse made available by backward pricing are so significant that they necessitate its statutory abolition for sales and for redemptions. The C.M.F.A. rule referred to in paragraph 13.61 is in our opinion not adequate to resolve these abuses. We note in paragraphs 13.61 to 13.62 that the rule leaves open the prospect of an advantage for the purchaser who can estimate whether N.A.V.P.S. has increased or decreased since its last computation. In addition, even if the principle of the C.M.F.A. rule were to be accepted we are doubtful that the procedures specified would adequately resolve all the problems which could arise in the application of the rule.

13.66 Developments in the United States are relevant to the conclusion we have reached. There, rules of the National Association of Securities Dealers have long prescribed a procedure substantially similar to the C.M.F.A. rule, except that each N.A.V.P.S. figure became effective one hour after computation and, to reduce the flexibility available to purchasers, N.A.V.P.S. was required to be calculated or estimated twice daily. In spite of the lesser potentialities for abuse under this rule, the Securities and Exchange Commission found* that it was inadequate. Mutual funds were releasing N.A.V.P.S. determinations before the end of the prescribed hour, so that purchasers for a few minutes had their choice of prices; in other cases investors would estimate on the basis of market behaviour whether the next N.A.V.P.S. would be up or down from that currently in effect. Representatives of the United States industry suggested a requirement substantially similar to the C.M.F.A. rule, so that each newly determined N.A.V.P.S. would be immediately effective, but the Securities and Exchange Commission concluded that this would not adequately resolve the problem because estimates could still be made of whether N.A.V.P.S. had increased or decreased since the last computation. The Commission accordingly concluded that forward pricing should be required in all cases, and has since

* Investment Company Act of 1940, Release No. 5413, June 25, 1968.

implemented such a requirement by rule 22c-1 under the Investment Company Act of 1940.

13.67 We agree with the conclusion reached by the Securities and Exchange Commission. No matter how frequently N.A.V.P.S. is required to be computed, and how rigorously requirements are enforced that each price become effective on computation, there will be occasions when it will be possible to predict that the next N.A.V.P.S. will be higher or lower than that currently in effect. On such occasions it will be possible for purchasers to effect transactions based on that prediction, thereby gaining an advantage at the expense of continuing shareholders or unitholders. For that reason, we have concluded that mutual fund shares or units should be sold or redeemed only at an N.A.V.P.S. calculated as at a time after receipt of a firm order by the mutual fund sales company or its agent. Appropriate procedures for verification of the time of receipt should be required.

13.68 Representatives of mutual funds which are sold through brokers have expressed strong opposition to the conclusions reached above. The principal argument upon which the opposition is based is that clients of brokerage firms are accustomed to being quoted firm prices on their securities and that this would be impossible under a forward pricing rule for shares or units of mutual funds. We do not accept this argument. Apart from the point that it is in fact not possible to quote a firm price at which securities in the public trading markets will be purchased until the purchase has been effected, it seems to us both reasonable and desirable that there be some differences between purchases of mutual fund shares or units and of other securities. Such differences recognize that mutual funds should be regarded primarily as vehicles for long-term investment. It is also important that orders for shares or units of mutual funds usually specify the dollar value to be purchased rather than a specific number of shares or units, although the latter type of order would be feasible. It is principally because of the general practice of ordering a dollar value rather than a specific number of shares or units that we conclude in paragraph 10.42 that no change should be required in the existing practice under which sales charges are quoted as percentages of the amount paid by the

purchasers rather than of the amount invested in the mutual fund. Purchases by dollar amount rather than number of shares or units are facilitated by most distribution companies, which are prepared to compute the number of shares or units acquired to the fifth place of decimals.

13.69 The second question enumerated in paragraph 13.59 is the frequency with which N.A.V.P.S. should be computed. Canadian practice on this at the end of 1967 is indicated by Table XIII-A, which shows the frequency of computation of N.A.V.P.S. for mutual funds qualified for sale in Canada. Computation was on a daily basis for most mutual funds, and these included all except three of the mutual funds the shares or units of which were sold at a basic sales charge rate in excess of 8.0%. In only two cases was the computation less frequent than monthly. With a forward pricing system, unfairness to other participants would not result from computations of N.A.V.P.S. made less frequently than daily. We have therefore concluded that a requirement for daily N.A.V.P.S. computation is unnecessary.

TABLE XIII-A

FREQUENCY OF COMPUTATION OF N.A.V.P.S.
OF MUTUAL FUNDS QUALIFIED FOR SALE IN CANADA AT DECEMBER 31, 1967

Frequency of Computation	Number of Mutual Funds for which N.A.V.P.S. is Computed at each Level of Frequency	Percentage of Total Net Assets Represented by Mutual Funds at each Level of Frequency
Daily	85	92.307%
Twice-weekly	1	.053
Weekly	5	.995
Twice-monthly	6	.954
Monthly	19	5.684
Quarterly	2	.007
	118	100.0 %

13.70 Although we have concluded that daily N.A.V.P.S. computation should not be required, we have also concluded that a provision for maximum delays between computations is desirable. This is not only because computations might otherwise be made so infrequently as to be inconsistent with the concept of a mutual fund, but also because persons purchasing shares or units would otherwise derive limited benefit from their money for an extended period. Many investors purchasing shares or units in a mutual fund which has its N.A.V.P.S. computed less frequently than daily pay their money to the distribution company for application to the mutual fund when N.A.V.P.S. is next computed. In paragraph 7.37 we conclude that the mutual fund rather than the custodian should receive the benefit of interest on this money, but the interest would ordinarily benefit all participants in the mutual fund rather than the persons with whose money it was earned. We have concluded that there should be an upper limit on the length of the period which may elapse between computations, and that N.A.V.P.S. should be computed for all mutual funds no less frequently than once in each month.

13.71 For the reasons set out in this section, we recommend:

(1) that sales and redemptions of mutual fund shares or units should be implemented at a N.A.V.P.S. computed as at a time after the receipt of a firm order by the distribution company or its agent, and that implementation of sales or redemptions at a N.A.V.P.S. computed as at an earlier time, referred to as "backward pricing" should be prohibited; and

(2) that the N.A.V.P.S. for a mutual fund should be computed no less frequently than once in each month.

Prohibition of Secondary Markets in Shares or Units

13.72 In paragraphs 10.52 and 10.53 we discuss two of the arguments advanced by members of the mutual fund industry against the prohibition of retail price maintenance. We there state that while the problems raised are of concern to us, we feel that they relate to the development of secondary markets in mutual fund shares or units rather than to retail price maintenance; they have persuaded us not that retail price maintenance should be permitted,

but that secondary markets should be prohibited. We explain the nature of a secondary market in paragraph 2.56. A dealer in securities can accumulate an inventory of shares or units in one or more mutual funds, and can service orders for purchases and sales without recourse to the distribution company. He is able to attract customers both by prompt service and by paying more for shares or units sold to him than the mutual fund would pay on their redemption, and charging less for shares or units sold by him than the distribution company would charge on their sale.

13.73 The dealer who operates a secondary market is disliked by distribution companies for a major reason which may be valid from a business standpoint but is not valid as a matter of public policy. By his pricing policy he conflicts with the endeavour of distribution companies to maintain a uniform price structure, an endeavour that we regard as inconsistent with the development of adequate competition within the mutual fund industry. Our decision that secondary markets should be prohibited is based on very different considerations, and on the assumption that the prohibition of retail price maintenance will contribute to the development of competition. Two reasons have led to our conclusion against secondary markets. First, in Chapter XIV we conclude that certain responsibilities should be imposed on distribution companies in connection with the practices followed in the public sale of their shares or units. Such responsibilities could not be performed if dealers were permitted to operate secondary markets at will.

13.74 The second reason for the prohibition of secondary markets is that the dealer is able to operate such a market in reliance on his ability to redeem shares or units at any time. The dealer who operates a secondary market in equity securities other than mutual fund shares or units must accept the risk in the accumulation of an inventory to service his customers that it might be impossible to liquidate that inventory at prevailing prices. The secondary market dealer in mutual fund shares or units can present his inventory for redemption at any time, regardless of whether it is a propitious time for the mutual fund to dispose of portfolio securities. Such an action could have a

severe adverse effect without any commensurate benefit to the mutual fund or its participants.

13.75 The conclusion that secondary markets in the shares or units of mutual funds should be prohibited leads to the question of the form the prohibition should take. The most obvious rule would prohibit the transfer of shares or units except as part of a transaction of sale or redemption effected by or through the distribution company. Such a rule would, however, raise more problems than it would resolve. Transfers between members of a family, including those arising on death, and other legitimate transfers would be encompassed within it.

13.76 We have concluded that the prohibition of secondary markets should focus on persons or firms registered to trade in mutual fund shares or units. This would allow the individual investor flexibility to deal with his shares or units as he thinks fit, provided that he does not engage in activities that would require him to register as a trader in securities. Each registrant under securities legislation should, then, be prohibited from participating in transactions which involve the purchase or sale of mutual fund shares or units except pursuant to an agreement with the distribution company concerned. Implementation of the conclusions concerning retail price maintenance in paragraphs 10.49 to 10.72 would prohibit distribution companies from refusing to sell to or through a particular registrant because the distribution company expected him to reduce his portion of the commission in favour of the customer.

13.77 The consequence of implementation of the conclusions reached in preceding paragraphs would be that all purchases of mutual fund shares or units would be effected through their issuance by the mutual fund, and all sales through their redemption by the mutual fund. This arrangement would be obviously unworkable for those mutual funds which are not permitted to sell their shares or units to the public because they have no prospectus currently effective. Very few instances of this type exist, but we have concluded that where, as a result of management decision or for other reasons, the shares or units of a mutual fund are not qualified for public sale, an exemption should be available from the proposed prohibition of secondary markets.

13.78 It is possible that the organizers of some mutual funds may wish their shares or units to be traded without being affected by the prohibition of secondary markets, even in cases where it is planned to maintain the qualification for public sale. We have concluded that this should be permitted, but only if the proposed arrangements satisfactorily resolve the two problems set out in paragraphs 10.52 and 10.53, and enable the conclusions set out in the next section to be adequately enforced. The appropriate administrator should have power to order that the prohibition proposed in paragraph 13.76 not be applicable to a mutual fund upon being satisfied as to these points.

13.79 For the reasons set out in this section, we recommend:

(1) that, subject to recommendations (2) and (3), persons and firms registered under applicable securities legislation to trade in securities should be prohibited from engaging in transactions which involve the purchase or sale of mutual fund shares or units, except pursuant to agreements with the distribution companies concerned;

(2) that the appropriate administrator should have power to exempt the shares or units of any mutual fund, named in the order, from the prohibition proposed in recommendation (1), upon being satisfied that adequate arrangements had been made for the following purposes:
   (a) to permit the distribution company concerned to adequately carry out its responsibilities in connection with the distribution process, as recommended in Chapter XIV;
   (b) to prevent dealers who participate in the operation of secondary markets from taking undue advantage of the availability of the right to redeem shares or units of the mutual fund concerned; and
   (c) to facilitate enforcement of the requirements proposed in paragraph 13.88; and

(3) that the prohibition proposed in recommendation (1) should not apply to shares or units of a mutual fund at any time when they are not qualified for sale to the public.

The Problem of Short-Term Trading

13.80 Throughout this chapter we stress that it is important to discourage short-term transactions in mutual fund shares or units. Implementation of the conclusions in paragraphs 13.65 to 13.68 concerning forward pricing would assist in the attainment of that objective, but would not alone be adequate for the purpose. Backward pricing is not the only feature of mutual funds which makes them attractive to short-term traders. Two other advantages would remain even after the introduction of compulsory forward pricing. First, except in the rare cases where the mutual fund has different purchase and redemption prices to reflect brokerage costs, the purchase of mutual fund shares or units provides an indirect investment in a portfolio of securities without any payment of brokerage charges. Second, the mutual fund provides great liquidity; the investor may purchase or redeem in any quantity without concern as to the capacity of the market to absorb his order at prevailing prices. These are very significant advantages, particularly in the comparatively illiquid Canadian securities markets.

13.81 The attraction of mutual funds for short-term traders which arises from the two advantages described in the preceding paragraph is offset only by the fact that sales charges must ordinarily be paid on the acquisition of shares or units; management fees are not ordinarily an important consideration to the short-term trader. Sales charges are a major discouraging factor, except in cases where they can be avoided or are so low that they do not offset the advantages to be gained from the mutual fund investment. There are two principal such cases: shares or units which are sold at a low basic sales charge rate or without sales charges, and shares or units sold at the prevailing sales charge rates but sold in such large quantities that the purchaser is able to take advantage of the volume discounts described in paragraphs 2.18 to 2.20.

13.82 While short-term trading is theoretically available to any investor through the purchase and redemption of shares or units sold without sales charges or at low sales charges, our observations indicate that larger purchasers are those who most frequently engage in this practice. One reason for this is that in the case of most mutual funds the shares or units of which

are sold at sales charge rates below those which prevail within the industry, N.A.V.P.S. is computed less frequently than daily. This constitutes a significant impediment to the short-term trader. The large volume purchaser is, however, able to take full advantage of mutual funds for which N.A.V.P.S. is computed daily because, through volume discounts, he can effect his purchase at a reduced sales charge rate which may be as low as 1/2 or 1/4 of one per cent.

13.83 The arguments against short-term trading which are advanced in paragraphs 13.04 to 13.06 are sufficiently strong, and its potential adverse impact on mutual funds sufficiently significant, that we have concluded in favour of a proposal designed to penalize those who engage in the practice. The most effective such penalty, and the most advantageous to the mutual fund, would be to require the short-term trader to make payment to the mutual fund in recognition of the advantages gained through his improper use of what should be a long-term investment. Such a payment would be in part designed to compensate for brokerage expenses incurred by the mutual fund to service the investment and subsequent redemption, but it would also relate to the less directly measurable harm done to the mutual fund; the most important example of the latter would be the difficulty caused by the transaction in the effective management of the investment portfolio.

13.84 In theory the penalty we propose should apply to all short-term traders, and especially to all who purchase at low sales charges or without sales charges. We have, however, concluded that only the larger purchaser should be affected. This conclusion is based not only on our observation that larger purchasers are those who make principal use of short-term trading as a technique, but also on the fact that the administrative difficulties involved in application of our proposed rule to all transactions would outweigh any advantages to be gained. We have concluded that any purchaser of shares or units to a value in excess of $50,000 should be subject to a penalty, payable to the mutual fund by reduction of the redemption price, of 4% of his redemption price if he redeems his shares or units within 90 days, and of 2% of his redemption price if he redeems his shares or units within six months. The penalty would not apply when an inter-fund transfer was made during the period, unless the shares or units acquired on the transfer were redeemed within the period.

13.85 Administrative problems will be involved in the implementation of the conclusion set out in the preceding paragraph. These problems might be major but for the proposal made in paragraphs 13.72 to 13.78 concerning the prohibition of secondary markets in shares or units of mutual funds. Under that proposal it will be feasible for distribution companies to keep track of shares or units sold in large blocks, and to arrange for the deduction from the redemption price of the appropriate amount when a redemption is effected within the designated period. Special records can readily be established by transfer agents or other persons responsible for the maintenance of lists of shareholders or unitholders to follow transfers between members of a family or arising on death; the penalty should apply on the redemption of any shares or units sold in a purchase of more than $50,000, even if they are subsequently split up by transfers so that the redemption is actually effected by a transferee who holds a substantially smaller amount.

13.86 We have considered many variations of the rules outlined above, the most important of which is that the penalty on redemption should be determined by reference to the sales charges initially levied. For example, if the shares or units were sold subject to a sales charge of 1% the penalty for redemption within 90 days would be reduced to 3% and that for redemption within six months would be reduced to 1%. We have concluded that this and similar alternatives do not adequately reflect the objective of the proposed penalty. Sales charges in no way compensate the mutual fund for the adverse consequences of the short-term transaction, since they accrue directly to the benefit of the distribution company. It would be consistent with our proposed rule for the distribution company to refund all or a portion of the sales charges to the redeeming shareholder or unitholder to reduce the amount of the penalty payable by him, but that is the only way in which it would be appropriate for sales charges to affect the proposed penalty. Distribution companies which believe the rule may restrict sales will presumably undertake to inform purchasers that they will make such a refund if the purchaser finds it necessary to effect a short-term redemption.

13.87 Because of the necessity to adopt appropriate administrative procedures, and because such procedures will in large part be dependent on the implementation of the conclusions reached in the preceding section, we have concluded that the rules outlined in this section should be applied only after the prohibition of secondary markets has become fully operative.

13.88 For the reasons set out in this section, we recommend:

(1) that a penalty should be payable for early redemption of shares or units purchased in a transaction involving in excess of $50,000, and that such penalty should be computed and paid in accordance with the following provisions:

(a) if the redemption is effected within 90 days after the purchase, the penalty should equal 4% of the redemption price; if it is effected within six months after the purchase, the penalty should equal 2% of the redemption price;

(b) the penalty should be recovered by the mutual fund through deduction of the appropriate amount from the redemption price of the shares or units redeemed;

(c) the penalty should not be adjusted to reflect sales charges paid on the acquisition of the shares or units redeemed, but the distribution company should be permitted to refund all or a portion of such acquisition charges to the person effecting the redemption; and

(d) the penalty should be payable with respect to a redemption of shares or units purchased in a transaction involving in excess of $50,000 regardless of whether all of such shares or units were redeemed and regardless of whether they had subsequently been transferred; and

(2) that legislation which implements recommendation (1) should not be implemented until after the implementation of the recommendations in paragraph 13.79 as to the prohibition of secondary markets.

Issuance of Shares or Units for a Non-Cash Consideration and Delivery of Portfolio Securities in Satisfaction of Requests for Redemption

13.89 Many of the problems discussed in earlier sections of this chapter arise from the necessity to express the value of an interest in an investment portfolio by a dollar figure, and to arrive at that figure with sufficient precision that shares or units may be issued and redeemed in reliance upon it. It might seem that at least some of those problems could be resolved if securities instead of cash were to be paid for shares or units issued, or were to be delivered for shares or units redeemed. While the right to deliver securities instead of cash can be of considerable value to the mutual fund in some circumstances, the use of securities instead of cash accentuates rather than resolves the problems of fairness with which we are concerned in preceding sections.

13.90 The use of anything other than cash as payment for shares or units sold or redeemed raises problems of fairness because purchasers or redeemers will be treated differently to the extent that the non-cash consideration paid or received by them is different. In addition, certain securities may be desirable to the mutual fund, and others not; receipt of the former or delivery of the latter would be beneficial to the mutual fund, but delivery of the former or receipt of the latter would be detrimental. Because of these problems, we have concluded that the payment for shares or units issued or redeemed should ordinarily be made in cash, with specified exceptions. This restriction would not apply to transactions effected by the distribution company or the management company to which the mutual fund is not a party, for such transactions do not raise problems with which we are here concerned. This would mean, for example, that the distribution company could purchase securities from a person interested in investment in the mutual fund, and could permit him to apply the proceeds to such an investment, without being affected by the rules we propose in this section. Any sale of these securities by the management company to the mutual fund would be subject to the restrictions proposed in Chapter IX as well as to the restrictions proposed in paragraph 13.99.

13.91 One general restriction should be adhered to with the issuance and the redemption of shares or units for a non-cash consideration. The only such consideration which should be permitted in any circumstances should be investments which satisfy the definition of liquid investments proposed in paragraphs 12.16 to 12.19. To permit the delivery or the acceptance of illiquid investments would involve major problems which would be difficult or impossible to resolve. In the following paragraphs we consider first the additional restrictions on the delivery of securities on redemptions, and then the restrictions on acceptance of securities in payment for shares or units issued.

13.92 There are two problems to be resolved in the determination of the circumstances in which delivery of investments from the portfolio of a mutual fund should be permitted in satisfaction of requests for redemption. The redeeming shareholder or unitholder might feel that he was being unfairly treated through the delivery of undesirable securities; for example, if he were to receive securities of a class which was infrequently traded and narrowly held, he might well believe them not to be worth the N.A.V.P.S. at which the redemption was purportedly effected. The other problem envisages the reverse situation, where the continuing shareholders or unitholders conclude that they have been unfairly treated as a result of the delivery to the redeeming shareholder or unitholder of the most desirable securities in the portfolio.

13.93 Balancing the potential difficulties referred to in the preceding paragraph are the potential advantages to be gained from the power to effect redemptions of shares or units by the delivery of securities instead of the payment of cash. The most important situations in which this power might be advantageous are those where the dollar volume of redemptions is so great that they cannot be met from the proceeds of sales or from the cash position of the mutual fund. This might occur when a large holder presents his shares or units for redemption. In one instance, a holder of shares having a value of approximately $38.5 million in a Canadian mutual fund presented them for redemption, and was given (by agreement) portfolio securities instead of cash. If the mutual fund in that case had been forced to liquidate securities to raise the necessary cash, adverse consequences might well have followed for the Canadian securities markets.

13.94 A large dollar volume of redemptions might also occur as a result of an unusually large number of smaller holders effecting redemptions in a short period. We are not unduly troubled by this possibility, for it seems to us unlikely to occur except as a concomitant of a general financial collapse in which mutual funds would probably be forced to resort to a more drastic remedy such as the suspension of redemptions, discussed in the next section. The figures in Appendix "B" indicate that it is rare for the volume of redemptions to exceed the volume of sales. Still, many shareholders or unitholders could make a simultaneous decision to redeem and it must be recognized that the delivery of securities instead of cash would be of great value in avoiding a hasty and disadvantageous liquidation of investments to raise necessary cash.

13.95 In arriving at conclusions as to the circumstances in which the delivery of securities instead of cash should be permitted on redemptions, it is relevant that this is an infrequent practice in Canada at present, although it is permitted under the organizational documents of many mutual funds. Presumably its infrequency results from competitive factors; purchasers of shares or units rely on the right to redeem for cash, and if one mutual fund acquires a reputation for delivering securities instead of cash it may thereby be placed at a competitive disadvantage. In an emergency situation, the power to deliver securities would probably be used, with results that could be beneficial to all parties involved. We have concluded that legislation should permit the delivery of securities instead of cash in satisfaction of redemption requests, but should include restrictions designed to ensure fairness and to make clear that this procedure is not to become a general practice.

13.96 The restrictions on delivery of securities instead of cash in satisfaction of redemption requests should vary depending upon whether the delivery is effected with the consent of the redeemer. Where the redeemer agrees to the delivery of securities in satisfaction of his redemption request, there will be no unfairness to him in such delivery. The reluctance of the investment manager to sacrifice desirable securities, supplemented by publication of relevant information in the annual report, would protect against delivery of the most desirable securities on a redemption. We have therefore concluded that

delivery of securities instead of cash in whole or partial satisfaction of a redemption request should be permitted if the written consent of the redeeming shareholder or unitholder is obtained. The securities should be valued at an amount no less than the value that would be placed on them in the determination of N.A.V.P.S., and details of the transaction, including a list of the securities delivered, should be included in the next annual report of the mutual fund.

13.97 If the responsible persons in the mutual fund organization wish to deliver securities instead of cash in whole or partial satisfaction of the redemption request, and cannot obtain the written consent of the redeemer, we think it necessary for the appropriate administrator to pass on the question. In these cases notice should be given to the administrator, with a copy to the redeemer, providing details of the redemption and of the securities proposed to be delivered, the value of which as used for computation of N.A.V.P.S. should equal that of the shares or units redeemed. The delivery of securities instead of cash could be proceeded with unless the administrator ordered within seven days that cash be paid.

13.98 We have considered whether to recommend that a dollar limit be imposed below which delivery of securities on redemptions would not be permitted without consent of the redeemer. We have decided against such a recommendation. In view of experience to date, we do not think that this procedure will be followed except with very large redemptions; its restriction to large redemptions will be further encouraged under our proposals, which involve procedural requirements that the mutual fund organization would not wish to follow except in unusual cases. These rules would also provide the appropriate administrator with ample power to protect the smaller redeemer. Our conclusion is further supported by the fact that such a dollar limit would provide an evasionary device, for a large holding could be broken down into a number of small holdings prior to redemption.

13.99 Issuance of shares or units for a consideration other than cash can be dealt with more simply than can delivery of portfolio securities on redemption. We have concluded that such transactions should be permitted only if the securities received complement an investment programme of the mutual

fund. Such a transaction can, in some circumstances, be a considerable benefit both to the mutual fund and to the purchaser. The mutual fund may acquire, without paying brokerage, securities that might not otherwise be readily available. The purchaser may receive the benefits of a diversified portfolio without having to accept the risks involved in the liquidation of his present holdings. Transactions of this type are presently comparatively rare, because of securities law restrictions on trading except through registrants and probably also because of a feeling on the part of mutual fund organizations that they might be subject to criticism if they participated regularly in these transactions. We think that these transactions might become more common if official guidelines were available under which they could be implemented.

13.100 We have concluded that the restrictions on self-dealing transactions proposed in Chapter IX would be sufficient to control the most likely abuses in this area, and that the principal control required on the issuance by mutual funds of shares or units in exchange for securities is disclosure. Such transactions should be implemented by a mutual fund only if its prospectus, or its most recent annual report if it has no prospectus, provides a clear indication that they are contemplated, and includes a statement that they will be implemented only when beneficial to the investment programme of the mutual fund. Each annual report should contain a clear statement of all such transactions made in the year reported on, in aggregated form if there have been many of them but indicating clearly the securities acquired for shares or units. The value of shares or units issued should be required to be equal to or less than that of the securities acquired, using the valuation rules applied in the determination of N.A.V.P.S.

13.101 For the reasons set out in this section, we recommend:

(1) that acceptance by a mutual fund of illiquid investments as defined in paragraph 12.29 , recommendation (2)(a), in payment for shares or units issued, or delivery by it of illiquid investments in payment for shares or units redeemed, should be prohibited;

(2) that delivery of liquid investments as defined in paragraphe 12.29 recommendation (2)(b), in satisfaction of a request for redemption should be permitted if:

(a) the written consent of the redeeming shareholder or unitholder is obtainted and details of the transaction, including a list of the securities delivered, are included in the next annual report of the mutual fund; or

(b) written notice is given by or on behalf of the mutual fund to the appropriate administrator, with a copy to the redeeming shareholder or unitholder, indicating the intention to deliver specified securities in satisfaction of the request for redemption and the appropriate administrator does not order within seven days that cash be paid instead;

on deliveries of securities pursuant to this recommendation, the securities delivered should be valued at an amount equal to or greater than their value for purposes of computation of N.A.V.P.S.; and

(3) that issuance of shares or units in exchange for liquid investments should be permitted if:

(a) the prospectus of the mutual fund, or its most recent annual report if it has no prospectus currently in effect, clearly indicates that such transactions are contemplated, and includes a statement that they will be implemented only when beneficial to the investment programme of the mutual fund;

(b) each annual report includes a clear statement of all such transactions effected in the year reported on, which statement may be in aggregated form if there have been many such transactions but should indicate clearly the securities acquired by the mutual fund in exchange for shares or units issued by it; and

(c) the value of the shares or units issued should be equal to or less than the value of the securities acquired, with valuation being determined in accordance with the rules applicable for computation of N.A.V.P.S.

Suspension of Redemptions; Time Within Which Redemption Payments Must be Made

13.102 The stress we place upon the right of redemption in this chapter and throughout this report indicates the importance which we attach to that right. Without it, the mutual fund industry would be very different; many of the problems that concern us would disappear, but with them would go some of the most important features of mutual funds for the investor. It is doubtful that the industry would have experienced the rate of growth which it has attained without the complete liquidity provided by the availability of the right to redeem, coupled with exact price quotations on a regular basis. In addition, the lack of availability of the right to redeem would have made it extremely difficult for distribution companies to engage in the continuous sale of shares or units which is another hallmark of the industry; apart from that right, a market price would have been established, which might be higher or lower than the distribution price.

13.103 The right of redemption is of such importance that the investor is entitled to be protected against an unjustified termination of that right. On the other hand, if mutual funds were forced to continue to honour the right at all times and in all circumstances, situations could arise in which the results would be detrimental to the mutual fund, or to the economy, or both. Such situations could affect one or a few mutual funds, or the entire industry. Examples of the former would include a case, such as has occurred in the United States, where it becomes impossible to place an accurate valuation on securities which form a substantial part of the portfolio of one or a few mutual funds. Another instance would be cases in which, as a result of poor or unfortunate investment decisions, the mutual fund becomes extremely illiquid and cannot satisfy redemption requests except through hasty and disadvantageous liquidation of securities.

13.104 Situations in which continued acceptance of redemptions would produce detrimental results on an industry-wide basis could occur if, for some reason, a significant percentage of mutual fund investors decided to transfer to some other form of investment and presented their shares or units for redemption approximately simultaneously. A more possible occurrence might arise as a

result of a market recession, when a number of shareholders or unitholders might be forced to redeem in order to avoid further losses or to meet margin calls on their other investments. If mutual funds were forced to meet requests for redemption in such circumstances, or in any other case when a large volume of orders for redemption was received in a short period of time, the resultant forced sales of portfolio securities might have a very serious effect. Again, though, the rights of shareholders or unitholders must be considered before a decision is made to permit the mutual fund not to meet their redemption requests; some of them may have invested in mutual funds solely to attain liquidity to meet emergency situations.

13.105 Situations such as those discussed in preceding paragraphs in which it might be appropriate for a mutual fund not to meet redemption requests, are not the only problems with which we are here concerned. We have received a number of complaints from investors who are dissatisfied with the service provided on requests for redemption made when no such situation was present. In some cases the mutual fund, or the distribution company which arranges for the redemption, delays in order to send representatives to the redeeming shareholder or unitholder in an attempt to persuade him to withdraw his request. We do not object to such attempts at persuasion, but we do not feel that they constitute a justification for a delay in making payment pursuant to the redemption. Undue delay is inconsistent with the liquidity which is one of the most important features of a mutual fund.

13.106 The Investment Company Act of 1940 requires that redemptions be effected within seven days after receipt of the appropriate documentation, except during any period when trading on the New York Stock Exchange is suspended or restricted; during any period of emergency as a result of which it is not reasonably practicable to dispose of portfolio securities, or to perform a valuation of assets; and during any other period that the Securities and Exchange Commission may permit for the protection of shareholders or unitholders. We agree with the principle of these provisions, and have concluded that similar provisions should be adopted in Canada.

13.107 We understand that some of the mutual funds which have been slow in satisfying redemption orders have relied on inadequacies in the material supplied to them in support of those orders. Practices differ on the material necessary to order a redemption, and a considerable amount of time can be consumed with requests for further documentation. We have concluded that the material with which the shareholder or unitholder is supplied as evidence of his holding should be required to include a clear statement of the procedures to be followed and material to be supplied to effect a redemption. This conclusion does not imply that the shareholder or unitholder must be given a certificate to establish his holding; the statement could be included on a receipt or other document. This statement would augment the value of a requirement that redemptions be effected within seven days after receipt of the relevant order, and discussed in the preceding paragraph.

13.108 Canada has no single stock exchange which has the degree of national recognition accorded the New York Stock Exchange in the United States, so that it would not be feasible to embody in legislation a provision that mutual funds could cease satisfaction of redemption orders during a period when the operations of a specified stock exchange were suspended. We have concluded, however, that the principle of such a provision can be more effectively carried out through another type of requirement. A mutual fund should be permitted to suspend redemptions of its shares or units during any period when trading is suspended on a stock exchange on which securities equal to 50% or more by value of the mutual fund's total assets, without allowance for its liabilities, are listed. This would extend to foreign as well as Canadian stock exchanges so that a mutual fund with extensive holdings in United States securities could suspend redemptions if the New York Stock Exchange were to suspend trading, provided that securities equal to 50% or more by value of the mutual fund's total assets were listed on that Exchange.

13.109 With the exception of the single case discussed in the preceding paragraph, we feel that mutual funds should not be permitted to suspend redemptions without the consent of the appropriate administrator. However, it might not be feasible to obtain that consent sufficiently quickly if the

relevant legislation is provincially administered. We have therefore concluded that if the legislation is not administered by a single national body, a mutual fund or its management or distribution company should be permitted to suspend redemptions on its own authority for either of the two reasons permitted under the 1940 Act: that the disposal by the mutual fund of securities owned by it is not reasonably practicable, or that a valuation of the assets of the mutual fund is not reasonably practicable.

13.110 Notice of any suspension effected pursuant to the conclusion in the preceding paragraph should be given forthwith to the appropriate administrator, and the suspension should not be permitted to continue for more than seven days without an order or orders to that effect given pursuant to the general power of the administrators. This general power of the appropriate administrator would authorize him to permit the suspension of redemptions by one or more named mutual funds, or by all mutual funds, for a specified period.

13.111 For the reasons set out in this section, we recommend:

(1) that a clear statement of the procedures to be followed and material to be furnished in connection with a request for redemption should be included in the documents with which the shareholder or unitholder is supplied to constitute evidence of his holding; such documents could be certificates, receipts, or other relevant documents;

(2) that, subject to the following recommendations, a mutual fund should be required to make payment pursuant to an order for redemption within seven days after receipt of the material specified in the statement supplied pursuant to recommendation (1); and

(3) that a mutual fund should be permitted to suspend redemptions of its shares or units in any of the following circumstances:

(a) during any period when trading is suspended on any stock exchange, within or outside Canada, on which securities are listed which represent more than 50% by value of the total assets of the mutual fund, without allowance for liabilities;

(b) if the relevant legislation is provincially administered, the suspension should be permitted on the authority of the mutual fund, management company or distribution company either because the disposal by the mutual fund of securities owned by it is not reasonably practicable, or because a valuation of its assets is not reasonably practicable; provided that notice of any suspension effected pursuant to this provision should be given forthwith to the appropriate administrators, and the suspension should not be continued for more than seven days except pursuant to an order made under clause (c); and

(c) the appropriate administrator should have power to permit one or more named mutual funds, or all mutual funds, to suspend redemptions for a specified period.

CHAPTER XIV

DISCLOSURE AND SALES PRACTICES

14.01 The mutual fund industry is strongly sales-oriented. This is not a criticism; indeed, but for the emphasis on sales it is unlikely that mutual funds would have experienced their rapid growth or would now loom large in the Canadian economy. The sales activities which have resulted in the success of the industry do not consist of passive order-taking. Distribution companies actively solicit orders, principally through salesmen "on the road" and through advertising and similar techniques. These techniques are of greatest importance with the mutual funds which are sold subject to a basic sales charge rate in excess of 8.0%, and make the principal appeal to the unsought goods segment of the market. Active solicitation of sales is not, however, confined to the distribution companies of those mutual funds; some of the trust companies which sponsor investment funds for public participation engage in active advertising campaigns to persuade the public to purchase units in these funds.

14.02 In this chapter we are concerned with the techniques used by the mutual fund industry to solicit orders, and with the disclosure made to purchasers. We deal to only a limited extent with the distribution company as order-taker for unsolicited purchases. This is for two reasons. In cases where the purchase is unsolicited, the purchaser is almost certainly one for whom mutual funds are shopping goods, and therefore one who requires protection less than do other purchasers. Secondly, these transactions are often effected

through brokerage firms and other financial institutions which handle them as part of their normal activities. Adequately to deal with such transactions would require a complete analysis of the procedures followed by these institutions, something which does not fall within our purview. The recommendations made in this chapter would affect the operations of brokerage firms and other institutions which choose to engage in active solicitation of orders for investment in mutual funds, a result which seems appropriate.

14.03 Mutual fund distribution companies are far from the only organizations which lay great stress on the sales function. Many consumer products are sold through similar techniques; brushes and cosmetics are two obvious examples. The example most frequently alluded to by participants in the mutual fund industry is life insurance, which is not only sold in the same way but often competes for the same dollars as mutual funds. Our responsibility is for an analysis of the mutual fund industry, and does not permit us to be deterred from recommendations for requirements that we think desirable simply because similar requirements are not applicable to life insurance companies. It is, however, appropriate for us to shape our recommendations so that any resultant competitive disadvantage for mutual funds will be minimal. This we have done; as a result, we believe that implementation of all the proposals in this chapter would actually reduce the existing competitive disadvantage imposed on mutual funds by regulations governing sales activities. We propose the modification of some regulations presently applicable to mutual funds but not to life insurance companies, and the additional requirements we recommend are so designed as to minimize any potential competitive disadvantage.

14.04 Our remarks concerning the similarity of techniques used by the various organizations which actively solicit purchase orders from the public are not intended to imply that the regulatory scheme proposed in this chapter should, or could, also be applied to the other organizations. We think that it would be feasible to apply the scheme, or portions of it, in other contexts, particularly in the sale of life insurance. Presumably certain modifications would be required in the latter context; we have not studied the life insurance industry in sufficient detail to decide precisely what modifications would be

necessary. This should be determined by a careful analysis of potential consequences of the various provisions. Application of our proposals to the mutual fund industry should not be delayed pending the completion of such an analysis.

14.05 With very few exceptions, the proposals in this chapter are related, directly or indirectly, to disclosure. The information provided in the solicitation of sales, particularly by the salesman in face-to-face communication with the potential purchaser, is of great importance to the attainment of the effective competition at the consumer level which is one of the principal objectives of this report. In paragraph 10.33 we comment on the importance of that information to adequate public education. Apart from the long-term objective of public education, it is essential for investor protection that the activities of the salesman be controlled so that he will not "oversell" in any of the various ways open to him. This is important with the sale of any product, but is of particular importance with mutual funds both because of the amount of money frequently involved in purchases and because of the long-term nature of the commitment implicit in a mutual fund investment. Ideally such controls should be applied by the responsible organizations rather than by government, and we make proposals designed to accomplish this.

14.06 Many of the conclusions reached in this chapter should be considered together with the registration requirements proposed in Chapter VII. In the following two sections we discuss certain preconditions which should be imposed on sales organizations and salesmen before their registration is granted, to be applied in addition to the preconditions discussed in Chapter VII. We then consider the circumstances in which mutual fund salesmen should also be permitted to sell life insurance policies. Subsequent sections propose requirements which would be enforced in large part through the availability of the sanction provided by the necessity for continued registration. These include the delivery of a prospectus and a summary prospectus, as well as provisions concerning their content and the content of accompanying sales literature and confirmations of transactions. We also consider restrictions on sales practices, and the general question of rescission rights. The final section of the

chapter concerns annual and interim reports and their relationship with the prospectus.

Regulation of Salesmen: Generally Applicable Considerations

14.07 The attention given by regulatory authorities and others to the role of the salesman in the distribution of mutual fund shares or units properly reflects the importance of that role. The information the salesman conveys is, in many cases, largely determinative of the decision made by a prospective purchaser as to whether he will or will not effect a purchase. The representations he makes influence the purchaser's expectations from the investment. His counselling in budgetary procedures often influences the purchaser's decision concerning the dollar amount to invest. Even after the sale, the extent to which the salesman continues to take a personal interest in the purchaser can have a material impact on the success of the investment from the latter's viewpoint. This continuing contact is of particular importance with contractual plans.

14.08 The importance of the salesman would be sufficiently apparent from observation of the industry, but is amply confirmed by information compiled through the consumer survey conducted under our auspices. Many supporting statistics could be cited and some are provided where relevant to the discussion in this chapter, but those set out in Table II-D (included after paragraph 2.43) are particularly revealing. That table makes it clear that the great majority of the persons interviewed had been sold their shares or units by a salesman who took the initiative in contacting the purchaser, and that in approximately one-half of all cases the sale was made within a single visit. The persons interviewed in the consumer survey all held shares or units sold subject to a basic sales charge rate in excess of 8.0%. By contrast, in a survey we conducted of the holders of units in a trust company investment fund sold without sales charges and without a sales force, 84% of respondents replied that they took the initiative in effecting the purchase.

14.09 We believe that regulations applicable to the selling techniques of salesmen should be designed to attain two principal objectives: to ensure that adequate information is provided to purchasers, and to avoid the

sale to a purchaser of an investment that is not appropriate for him, unless he fully understands the implications of the purchase. It is obvious that these two objectives are closely related, since perfect attainment of the first would guarantee the second. The methods appropriate for them are, then, very similar. Three principal methods should be used; they are discussed briefly in following paragraphs, and in more detail in following sections. The first two form part of the existing regulatory structure, with substantially similar objectives. The third is given little emphasis in the existing regulatory structure.

14.10 The first method to attain the objectives of regulations over salesmen focusses on the selection and training process. The theory is that if the right man is selected and if he is given adequate training, he will make "good" sales, in other words, sales to customers who understand the implications of their purchase and for whom the purchase is a proper investment. The second method focusses on the procedures followed in the sales process. In implied recognition that the verbal content of the salesman's presentation cannot effectively be controlled, requirements are applied to the literature used; the most important manifestation of this is in the prospectus requirements discussed later in this chapter. Restrictions are also applied on certain activities in which the salesman might engage; the restriction on sales at residences, discussed in paragraphs 14.80 to 14.88 is an important example.

14.11 We recognize the merits of each of the two methods for the control of salesmen which are discussed in the preceding paragraph. The emphasis given these methods should not, however, be permitted to obscure the value of the third method, which has received less attention from regulatory authorities in the past. This involves recognition of the importance of the internal procedures established by the sales organization for the supervision of salesmen. This aspect of the sales function was emphasized in a brief submitted to us by an independent sales force:

> It is important to remember the essential simplicity of a mutual fund. A salesman does not need to be an amateur investment analyst - he has only to know what his product is and how it can be used. The C.M.F.A. Course provides good basic knowledge of the industry,

and from there the distributor company is responsible for training its people adequately. We do believe it is most important that there be competent people in every distributing company to back up the field salesman and provide expert advice and assistance in more complex cases.*

This quotation may underestimate the importance of the salesman's own knowledge and qualifications, but we think the principal point it makes is a correct one, that the salesman must be supported by competent persons in his organization. This is necessary not only so that they can assist him with complex cases, but so that they can maintain adequate supervision over his activities.

14.12 In the specific proposals made in following paragraphs for the application of the three methods summarized above, we avoid a rigorous scheme of control which would unduly restrict the operations of sales forces. In several instances, implementation of our proposals would modify rather than extend regulations presently in effect. As noted in paragraph 14.03, the scheme we propose, considered in its totality, would be less restrictive than that presently in effect. This result is attributable in large part to certain premises accepted by us. In a free economy sales forces should be allowed to function unless some valid public policy motive is found for their abolition. We are aware of no such public policy motive. Indeed, the contrary is the case, for there is reason to believe that mutual fund sales forces have made an important contribution to the economy and to the welfare of individual investors through expansion of the extent of public interest in equity investments. We have therefore taken care in the formulation of our recommendations to avoid undue interference with the continued effective and profitable operation of sales forces, and similar care should be taken in the implementation of these recommendations.

14.13 For the reasons set out in this section, we recommend:

(1) that regulations applicable to sales forces and salesmen should be principally designed to result in full disclosure of relevant information to prospective purchasers so that investments are made with a

* DesBrisay, Submission to the Canadian Committee on Mutual Funds and Investment Contracts on behalf of Great Pacific Management Co. Ltd. (Victoria, 1968) page 15 (the underlining is ours).

complete understanding of their implications, and to avoid sales which are inappropriate for the investors concerned unless these inestors fully appreciate the implications of their purchases;

(2) that the objectives set out in recommendation (1) should be attained by three principal methods, discussed separately in following sections:
   (a) restricting admission as salesmen to properly qualified persons, and applying requirements to the training they must undergo;
   (b) verifying that sales forces have available adequate supporting staff to supervise the salesman and to assist him with problems as they arise; and
   (c) applying requirements concerning procedures followed by the salesman at the time of sale; and

(3) that requirements designed to carry out the methods referred to in recommendation (2) should be so formulated that they will not prevent the continued effective and profitable operation of sales forces.

Salesman Qualifications and Training

14.14 In paragraph 7.56 we propose that every salesman engaged in the public sale of mutual fund shares or units should be required to register as such. This is also a requirement under present law, but the registration requirement we propose would be substantially wider than that presently in effect. It would extend not only to the officers of registered organizations, but also to persons associated with various financial institutions who are not presently required to register as salesmen. In view of the scope of this requirement, it is appropriate to consider whether exemptions from it should be granted. The registration requirement is designed to facilitate the enforcement of rules which are formulated primarily for the protection of purchasers for whom mutual funds are unsought goods. It would therefore add little to the scheme of public protection to require the registration as salesmen of persons who sell only to purchasers for whom mutual funds are shopping goods. We have concluded that the administrators should be prepared to exercise their exemptive powers under the proposals in paragraph 7.19 in favour of such persons.

14.15 The conclusion that a salesman should not be subject to the registration requirement if he caters exclusively to purchasers for whom mutual funds are shopping goods is easily reached but difficult to implement. The administrators must make determinations on a case-by-case basis, but we believe that they would ordinarily be justified in granting an exemption to all salesmen associated with any organization that satisfies two requirements: it has no salesmen "on the road" to solicit purchases, and it levies no sales charge on shares or units sold. Such organizations would ordinarily appeal only to purchasers for whom mutual funds are shopping goods, although that would not always be true. The exemption should be withheld in cases where it is not true; for example, if the mutual fund pays a very large management fee which is partially used to compensate salesmen or if the distribution company conducts an extensive advertising campaign designed to appeal to purchasers for whom mutual funds are unsought goods. We comment in Chapter XVI on the application of this exemption to banks and trust companies.

14.16 The first of the three methods for the control of salesmen proposed in the preceding section is to impose preconditions on their registration designed to ensure that they are properly qualified. This is an area upon which considerable emphasis is placed by securities administrators. An application for registration must include detailed information concerning the applicant's personal background. While no province imposes minimum educational requirements or requires applicants to have a specified amount of capital, most provinces review applications to detect any suggestion of lax ethical standards as manifested by past behaviour. Two additional restrictions, each of them controversial, are imposed in most provinces: salesmen are not permitted to be dually licensed for the sale of life insurance and mutual funds, and salesmen who work on a part-time basis are discouraged or prohibited. These restrictions are considered in the following two sections.

14.17 Important though the review made by administrators of the applications for registration may be, it cannot be as effective as a thorough screening applied by the organization which retains the salesman. In this as

in the other aspects of salesman control discussed below, we strongly encourage the development and enforcement of high standards of conduct for salesmen. This should be done within the various sales organizations. The objective should be to have mutual fund salesmen view themselves, and be viewed by others, as professional persons subject to high ethical standards. Governmental requirements can enforce only a minimum standard of conduct. A prime example of this is the training experienced by mutual fund salesmen before they begin to deal with the public.

14.18 In all except one of the provinces, newly registering mutual fund salesmen are required to take and to pass the Canadian Mutual Funds Course; the only alternative is to pass the Canadian Securities Course, a more extensive and difficult course designed for those who propose to participate in a general brokerage business. Some sales organizations supplement the Canadian Mutual Funds Course with training courses of their own; in a few instances, these courses attain a high standard and are of considerable benefit to salesmen. That is particularly true when they endeavour to provide information concerning mutual funds instead of concentrating entirely on sales techniques. In other cases, the Canadian Mutual Funds Course is the only training which salesmen receive. That course, while valuable, in our opinion represents a minimum standard. The development by more distribution companies, independent sales forces, and brokerage firms with mutual fund sales forces of their own supplementary training programmes, containing information about mutual funds and related instruments, will be a necessary part of the drive towards professional standards for mutual fund salesmen.

14.19 The Canadian Mutual Funds Course was prepared and is administered by the Canadian Mutual Funds Association in co-operation with the administrators; in paragraph 19.33 we comment on the role of the C.M.F.A. in the administration of the course as it applies to non-members of the C.M.F.A. Two examinations are involved. The first, an easy test, is taken at an early stage and the administrator grants preliminary registration upon proof that it has been passed. The second examination is taken at the conclusion of the course.

Final registration issues upon passage of the second examination, provided that all other requirements have been satisfied. The provinces follow different policies on the maximum period that may elapse after the first test before the final examination is passed. The periods vary from six months to one year, except for one province which has no such policy.

14.20 The importance of educational requirements for mutual fund salesmen is, in our view, clear. We have concluded that salesmen should continue to be required to take and to pass a prescribed course prior to receipt of full registration. The period elapsed since the institution of the Canadian Mutual Funds Course has not been sufficient to permit us to estimate its worth on the basis of experience. We have reviewed the course and have concluded that, while far from an intensive analysis of the industry, it is adequate for the purpose. However, the course should be kept under continuing review in the light of experience, to ensure that it continues to reflect current developments and that the examination based on it constitutes an adequate standard for admission to the industry.

14.21 During the period of between six months and a year which is permitted to lapse after the preliminary test until the final examination is taken and passed, the applicant for registration is permitted to sell shares or units to the public. The illogic of this arrangement is readily apparent. If it is desirable for investor protection that the course be taken at all, presumably the result is to deny some element of protection to investors who are approached by the salesman during the initial registration period. Our review of the content of the preliminary examination has convinced us that it is a nominal requirement. Anybody with the slightest understanding of a mutual fund should be able to pass it easily, and we do not believe that a person should be regarded as qualified to engage in public sales of shares or units merely because he has passed this preliminary examination.

14.22 Ideally, the initial registration period should be discontinued and passage of the final examination made a precondition to authorization to sell. We have concluded that this should be the applicable requirement for any part-time salesmen to whom registration is granted under the proposals in

paragraphs 14.37 to 14.40; such salesmen will ordinarily have another source of income and it should be feasible for them to take the full course and examination prior to registration. We recognize the difficulties which would result for the mutual fund industry from the extension of this requirement to all salesmen. A serious financial burden would be imposed on the applicant, or on the distribution company, or on each of them. It would be necessary for the applicant to be supported while he was engaged in his studies, and the addition of the expense which this would require to that already necessary for registration fees and the costs of the Canadian Mutual Funds Course might well raise to an uneconomic level the initial financial burden involved in becoming a salesman. We have therefore concluded that the initial registration period should be retained for full-time salesmen, but that unless the preliminary test is made substantially more difficult, the period allowed to elapse between the two examinations should be reduced to three months. In addition, the review of orders proposed in paragraphs 14.45 to 14.48 should be made with particular care in the case of orders obtained by salesmen during the initial registration period.

14.23 We considered whether applicants for registration as salesmen should be required to satisfy any preconditions in addition to taking and passing the training course. To assist us, we made use of the consumer survey and other sources of information in an endeavour to ascertain whether there was any characteristic the presence or absence of which in a sales force or salesman would lead to "better" sales. A comparison between purchasers from two large sales forces, one of which had a lower turnover ratio, a higher average income per salesman and fewer part-time salesmen than the other, showed that there were differences between the two groups of purchasers which, while of interest, were not major. Purchasers from the former sales force had, on average, attained a higher educational and financial level than purchasers from the latter sales force, and the former group of purchasers were more likely than the latter to make comparisons prior to purchase. Some of these differences were at least partially explicable by the fact that the two sales forces concentrated their activities in different geographical areas. Both groups

of purchasers appeared equally satisfied with their investments. Neither this nor other analyses we conducted enabled us to isolate characteristics that would lead to better sales. For that reason, we have concluded that the requirements outlined in preceding paragraphs are all that should be imposed by administrative authorities on applicants for registration as salesmen.

14.24 The conclusion that additional requirements should not be imposed by administrators on applicants for registration is not intended to imply that we regard the specific procedures we propose as adequate to screen out undesirable applicants. The sales organizations have an important role to perform in the selection of salesmen. Perhaps their most important responsibility is to exclude salesmen who will remain for only a short period. These salesmen tend to effect sales only to their family and friends before realizing that they are not qualified to continue as salesmen. They lack the feeling of long-term commitment which is so essential for all participants in the securities industry. They do not provide adequate continuing service for their clients, and they often do not receive adequate training and experience. Securities administrators have long endeavoured to discourage high turnover of salesmen; both they and the mutual fund industry should continue this endeavour.

14.25 For the reasons set out in this section, we recommend:

(1) that the administrators should be prepared to exercise their power under paragraph 7.20, recommendation (6), to grant exemptions from the necessity to register as salesmen to those salesmen who sell exclusively to purchasers for whom mutual funds are shopping goods; in the absence of special circumstances which indicate a direct appeal to those for whom mutual funds are unsought goods, this should be considered to include all salesmen associated with any organization which satisfies the following conditions:

(a) it has no salesmen "on the road" to solicit purchases; and

(b) it levies no sales charge on shares or units sold;

(2) that every encouragement should be given to the development within the mutual fund industry of standards of conduct for salesmen which

will result in their viewing themselves, and being viewed by others, as professional persons subject to high ethical standards;

(3) that to further the attainment of professional standards among salesmen, more sales organizations should develop training courses to supplement the Canadian Mutual Funds Course with additional information concerning mutual funds and related instruments;

(4) that applicants for registration as mutual fund salesmen should continue to be required to take and to pass either the Canadian Securities Course or the Canadian Mutual Funds Course;

(5) that the Canadian Mutual Funds Course should be kept under continuing review for adjustment to reflect experience; it should reflect current developments and the examinations should constitute an adequate standard for admission to the industry;

(6) that part-time salesmen, defined in paragraph 14.41 should not be permitted to sell mutual funds until they have completed and passed one of the courses referred to in recommendation (4);

(7) that full-time salesmen who take the Canadian Mutual Funds Course should continue to be granted temporary registrations which authorize them to sell mutual funds during an initial period after passage of a preliminary examination and prior to passage of a final examination; provided that

  (a) unless the preliminary examination is made substantially more difficult, the initial period should not be permitted to last more than three months; and

  (b) the review of orders proposed in paragraph 14.49 recommendation (2)(b) should be conducted particularly carefully with orders received by a salesman during his initial period; and

(8) that administrators and, particularly, sales organizations should endeavour to select salesmen who will feel a sense of long-term commitment to the industry, and to avoid high salesman turnover.

Dual or Multiple Licensing

14.26 Traditionally in Canada salesmen have been denied concurrent licenses to sell mutual funds and life insurance. This denial has been the result of policies of the provincial Superintendents of Insurance, in which we understand that they have been to some extent influenced by the position of the life insurance industry that to permit mutual fund salesmen also to sell life insurance would result in a reduction of sales standards. This position and the reasons for it were stated as follows by the Life Underwriters Association of Canada, an association of life insurance agents, in its brief to us:

> LUAC experience confirms that increasing levels of knowledge and training are necessary for a life insurance agent to become professionally competent in our current society. Moreover, continuing training and education are necessary to keep up to date with rapid changes and new developments. LUAC tries to provide this opportunity through periodic life insurance refresher schools and CLU seminars on a regional basis. The demanding and specialized role involved in being a competent life insurance agent is a prime reason for LUAC policy of opposition to dual licensing of agents to sell both life insurance and mutual funds. Any sudden opening of the gates to dual licensing would, in our opinion, result in chaos and the public would suffer. The least competent performers in each field would be the first to grab for the straw of dual licensing to supplement their inadequate incomes. The evils of switching, misrepresentation and unethical practices would surely increase.*

14.27 In spite of the strong position taken in the quotation in the preceding paragraph, the next paragraph of the brief acknowledges that "opposing views exist even within the membership of LUAC although it appears the great majority are not in favour of dual licensing". The position set out in the brief of the Canadian Life Insurance Association, which represents life insurance companies, is somewhat similar although a different argument against dual licensing is emphasized:

> ... A great majority of member companies remains convinced that it would not be in the public interest for the same person to be licensed to represent both a life insurance company and an independent mutual fund organization. In such a case, neither institution would be able to ensure that the salesman would be satisfactorily financed in the early years and adequately trained to provide sound, balanced advice to his clientele.
>
> However, member companies are reviewing the question of the same person being licensed to represent a life company and a mutual fund where these institutions are linked through a parent-subsidiary

* The Life Underwriters Association of Canada, Submission to the Canadian Committee on Mutual Funds and Investment Contracts: (Don Mills, 1968) Pages 9-10.

relationship or third-party control. The survey indicated that if and when life companies were granted the power to have mutual fund subsidiaries, a number of companies - although still a minority of all members - would favour the same person being licensed to represent a life company and a mutual fund linked in either of the above ways.*

14.28 In paragraph 14.23 we note our inability to identify any characteristic the presence or absence of which in an individual will serve to identify him as a "good" salesman. The ability to be an effective salesman would seem to be a personality trait, unidentifiable by objective tests. Among the identifying characteristics we have considered and rejected is whether the salesman is exclusively engaged in the sale of a single product. Neither in logic nor on the basis of available evidence have we been able to conclude that there is a significant correlation between a salesman's ability to service the public and the range of products he handles, except to the extent that a positive correlation exists simply because the availability of a range of products provides the client with greater opportunity to choose. It is relevant that mutual fund salesmen have long been permitted to sell completion insurance on contractual plans, that investment contracts are sold by salesmen who also sell mutual funds, and that individual variable policies are sold by life insurance salesmen. We are not aware of any substantial problems which have arisen as a result of these arrangements.

14.29 Dual licensing is in our opinion a logical result of the growth in competition between the mutual fund and life insurance industries, which is itself only one example of competition among financial institutions. One result of the competitive position is the increasing availability of a variety of financial instruments from a single source. It is natural that salesmen should wish to provide this type of service to their clients. In the heading of this section the term "multiple licensing" is used; salesmen have already started to suggest that they should be permitted to sell other instruments as well, and we recognize that this is also a logical development. Dual or multiple licensing should not, in our opinion, be opposed in principle by government, although care must be taken to provide adequate protection for

* The Canadian Life Insurance Association, <u>Submission to the Canadian Committee on Mutual Funds and Investment Contracts</u> (Toronto, 1968) Page 35.

the investor. The proposals made in the remainder of this section relate specifically to dual licensing for mutual funds and life insurance, but we believe that similar approaches should be adopted for other types of dual or multiple licensing.

14.30 During the months preceding the time of writing, a few of the provincial Superintendents of Insurance have accepted the principle of dual licensing by granting licenses for the sale of life insurance to a few mutual fund salesmen. In doing so, the Superintendents of Insurance have rejected the conclusions drawn by the life insurance industry from the arguments against dual licensing, but they have recognized the principles of these arguments through a rigorous approach in the determination of what salesmen should be dually licensed. The arguments relate to two principal points: the difficulty in adequately training a salesman to sell two different products, and the difficulty in supervision if the mutual fund and life insurance organizations are separate. The first point has been recognized by careful selection of the salesmen to be dually licensed, restricting them to persons with good training and experience. The second point has been recognized by the limitation of dual licensing to cases where the mutual funds and life insurance to be sold are issued by related organizations.

14.31 We have concluded that dual or multiple licensing should be permitted on a less restrictive basis than that described in the preceding paragraph. An applicant for more than one license should be required to satisfy all the preconditions necessary for each license, in the form of training programmes and other requirements. This means that the Canadian Mutual Funds Course would be a precondition, as would any course prescribed for life insurance salesmen; such a course has been adopted in British Columbia, and work is in progress on similar courses in other provinces. Experience may indicate the desirability of a separate course which is designed specifically for salesmen who are to sell both mutual funds and life insurance, and the administrators should have authority to co-operate with the industries concerned in the development of such a course, and to impose a requirement that it be taken and passed as a precondition to dual or multiple licenses.

14.32 Restrictions on dual licensing should also recognize the considerations advanced in the quotation from the brief of the Canadian Life Insurance Association in paragraph 14.27. The importance of those considerations, which relate to the control and supervision of salesmen, is accentuated by the emphasis we place on the role of supporting staff in paragraphs 14.42 to 14.48. While it is apparent that divided responsibility for supervision of salesmen could make the regulatory function more difficult, we do not believe that this necessitates the restriction of dual licensing to cases where the organizations concerned "are linked through a parent-subsidiary relationship or third-party control". Such a restriction would effectively prevent salesmen for a mutual fund distribution company that did not have an associated life insurance company, or a life insurance company that did not have an associated mutual fund distribution company, from receiving dual licenses. This would put them at a serious, and in our view unnecessary, competitive disadvantage. Independent life insurance agents and independent mutual fund sales forces would be subject to a similar disadvantage. All of these organizations have a contribution to make.

14.33 The problem of supervision can be effectively resolved through the development of working relationships between organizations which are not linked by a parent-subsidiary relationship or through third-party control. Even where such a linkage exists requirements should be imposed to ensure that such relationships are developed; some organizations linked in these ways operate as completely separate entities. The arrangements between the organizations concerned should establish responsibility for the control and supervision of salesmen in all aspects of their activities, so that no such responsibility would be overlooked as a result of "falling between two stools". They should also include arrangements to avoid problems in the sale to a purchaser of mutual funds and life insurance on an inadequately integrated basis. The potential problems range from the sale to a single purchaser of an endowment life insurance policy and an insured contractual plan, investments which would rarely belong in a single portfolio, to minor problems of detail in the relationship

between arrangements or policies which were adequately integrated in principle. Procedures to ensure that combined policies or arrangements are properly integrated will become an increasingly important function as available contracts become more complicated.

14.34 Arrangements to carry out the objectives described in the preceding paragraph should be developed before a salesman is permitted to sell products issued by different organizations, even if those organizations are linked by a parent-subsidiary relationship or third-party control. The existence of such arrangements should be established by documents consisting of letters or agreements to be kept in the files of the sales organization and available for inspection by the administrator. The documents should allocate responsibility for the training, control and supervision of salesmen so that both the mutual fund and the life insurance aspects of their activities will be adequately dealt with. They should also specify the combinations of life insurance policies and mutual funds which could be sold to a single purchaser. In addition, they should describe the procedures to be followed so that purchases could be reviewed for the purposes described in paragraphs 14.46 to 14.48. Any other matters relevant to the relationship between or among the organizations concerned ought also to be dealt with in the documents.

14.35 We believe that the development of dual licensing is both inevitable and desirable, because of increasing competition among financial institutions and because of the public benefit which will result from that competition. The development of dual licensing will place additional burdens on administrators, sales organizations and salesmen. Responsible co-operation among them will ensure that these burdens are properly carried, and that no consequences detrimental to the public interest will result from the institution of dual licensing.

14.36 For the reasons set out in this section, we recommend:

(1) that government should not, in principle, be opposed to the development of dual or multiple licensing, provided that it is accompanied

by adequate safeguards for the protection of the public investor. The following recommendations relate specifically to dual licensing for the sale of shares or units of mutual funds together with life insurance policies, but similar approaches would be appropriate for other types of dual licensing and for multiple licensing;

(2) that, subject to recommendation (4), applicants for permission to sell both life insurance and mutual funds should, subject to the discretionary power of the administrator to reject undesirable applicants, be accepted if they satisfy all the preconditions imposed for each type of qualification;

(3) that, if experience indicates the desirability of a separate course designed for salesmen who are to sell both mutual funds and life insurance, the administrators should have authority to work with the industries concerned in the development of such a course, and to require that applicants for dual licenses take and pass it; and

(4) that, before a dually licensed salesman is permitted to sell life insurance and mutual funds issued by different organizations, arrangements should be made between those organizations to deal with the following matters; such arrangements should be established by documentation, in the form of contracts or letters, kept in the files of the sales organization concerned and available for inspection by the administrator:

(a) the arrangements should allocate responsibility for all aspects of the training, control and supervision of salesmen;

(b) the sale to a purchaser of inadequately integrated policies or arrangements should be avoided through specification in the documents of the policies or arrangements which could be sold in combination; and

(c) procedures should be designed for the review of transactions which seem inappropriate for the purchasers concerned, in accordance with paragraph 14.49, recommendation (2), clause (b).

Part-Time Salesmen

14.37 Canadian administrators are reluctant to accept applications for registration as salesmen from persons who intend to act as such only on a part-time basis. This reluctance is based in part on the experience of some of the larger sales forces which have encountered difficulties with part-time salesmen, and in part on disciplinary problems which have been experienced by securities administrators. The feeling is that such salesmen lack the sense of long-term commitment to the industry which is so important in a salesman who is to operate effectively in the public interest. In addition, such salesmen are said to be more difficult to control because most of them have available another source of income and are therefore not so dependent on the continued effectiveness of their registration as is a full-time salesman.

14.38 We have received submissions in favour of part-time salesmen which oppose the arguments summarized above. One submission, from an independent sales force, supports such salesmen on the basis that they possess the following advantages:

> (a) he does not sell to "eat", hence he is not under pressure to sell and our experience is he/she sells better business;
>
> (b) as a rule this person is retired or semi-retired professional person and is mentally well-equipped to learn the business;
>
> (c) from a company aspect, we have far less turn-over amongst our part-time people.*

14.39 We have been unable to establish any significant correlation between the time a salesman spends at his work and the percentage of "good" sales he makes, and have concluded that there is no inherent defect in part-time salesmen; as with salesmen generally, their quality varies with the individual. This conclusion is not surprising, given the variety of persons who might wish to become part-time salesmen. The quotation in the preceding paragraph is largely based on experience with retired professional persons for many of whom the sale of mutual funds may only supplement an otherwise adequate income. In several provinces there has been favourable experience with resi-

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* Isaac, Submission to the Canadian Committee on Mutual Funds and Investment Contracts on behalf of Great Pacific Management Co. Ltd. (Victoria, 1968) page 10.

dents of rural areas who have sold mutual funds on a part-time basis. On the other hand, obvious problems might result from the unlimited extension of the right to engage in part-time selling to any applicant.

14.40 The development of a greater degree of professionalism among sales forces may ultimately result in a self-imposed limitation to salesmen who are engaged on a full-time basis in the sale of financial instruments. We have concluded that such a limitation should not be enforced by government. This does not mean that applicants for registration as part-time salesmen should be encouraged; in paragraph 14.22 we propose that one requirement be imposed on them which is more rigorous than that applicable to full-time salesmen, through the denial of the right to sell during an initial registration period prior to passage of the final examination. The sales organization and administrator concerned should consider carefully the merits and background of each applicant who does not propose to treat the sale of financial instruments as a full-time occupation, and should be prepared to exercise their authority to refuse undesirable applicants. An important factor to be taken into account is the nature of the activities to be pursued by the applicant when he is not engaged in the sale of mutual funds.

14.41 For the reasons set out in this section, we recommend:

> that an application for registration as mutual fund salesmen should not be rejected merely because the applicant does not propose to treat the sale of mutual fund shares or units, alone or together with other financial instruments, as a full-time occupation, but that both the sales organization and the administrator concerned should carefully consider the merits and background of the applicant, with particular reference to any other activities to be pursued by him.

The Supporting Staff; the Know-Your-Purchaser Rule

14.42 In paragraph 14.11 we state that the internal procedures established by the sales organization for the supervision of salesmen should be taken into account in the regulatory scheme. We there set out a quotation from

a submission made to us which comments on the importance of "competent people in every distributing company to back up the field salesman and provide expert advice and assistance in more complex cases". It is apparent that a sales organization in which the supporting and supervisory staff is able and conscientious will present far fewer problems for the administrator than will one in which each salesman functions independently without contact with his central staff other than to receive commission payments. The benefits which such an organization can provide for customers are equally apparent. The crucial factor is the staff, and a difficulty is that the staff is not directly productive; its members do not earn commissions, but must be paid salaries. It is therefore understandable that many sales organizations are reluctant to support a staff of the size and quality necessary adequately to perform these responsibilities.

14.43 Another obstacle to the assumption by sales organizations of responsibility for effective continuing supervision over their own salesmen is that, under present practice, salesmen are considered to be independent contractors with the sales organization rather than its employees. This is almost invariably the case with direct sales forces and independent sales forces; it is less frequently true with salesmen associated with brokerage firms. One advantage of this relationship is that it enables salesmen to deduct their sales expenses from taxable income in the computation of income tax. Our observations indicate, however, that it detracts from the degree of continuing supervision over salesmen which we think desirable; if the legal relationship of salesmen with sales organizations were closer, the degree of supervision would be correspondingly increased. We do not propose that legislation should directly require a change in the legal nature of the relationship between salesman and sales organization. Such a change may well, however, be an indirect consequence of the implementation of our conclusions in Chapter X concerning the legislative provisions necessary to prohibit retail price maintenance. For reasons indicated in paragraph 10.70, the direct sales force organizations may wish to treat their salesmen as employees in order to avoid the impact of those provisions. This may also be true of the independent sales forces. Such changes would, in our view, be desirable.

14.44 Some sales organizations have established competent and effective supporting staffs. Others, partly because of the two factors discussed above and partly because the rapidity of their growth has exceeded their ability to train staff personnel, have failed to do this. Such supporting staffs will become increasingly important with changes in the structure of the mutual fund industry and with the increasing complexity of the range of financial instruments available to the public. We have concluded that the administrator should have authority to refuse an application for registration from, or to suspend the registration of, any sales organization if it is apparent that the organization lacks a staff adequate to carry out supporting responsibilities. This would apply to any sales organization which makes use of salesmen to sell shares or units of mutual funds, be it a broker, independent sales force or direct sales force. In the following paragraphs we elaborate on some of the principal responsibilities of the type of supporting staff we envisage.

14.45 Regardless of the quality of a training course given to a salesman, questions or problems will sometimes arise when he deals with clients which he will not be qualified to answer. The salesman who purports to advise his customer on an estate plan as an adjunct to the sale of mutual funds can be a menace unless he is able to rely on expert assistance. The advent of dual and multiple licensing, which will be accompanied by an attempt to provide clients with all aspects of a complete financial service, will increase the number of cases in which expert assistance is necessary. The supporting staff of a sales organization should be able to provide or should have access to, such expert assistance. It should also institute procedures which will effectively discourage salesmen from the attempt to advise clients on complicated legal and financial questions which the salesmen are ill-equipped to discuss.

14.46 The most important continuing responsibility of the supporting staff should be for salesman training, considered in the wide sense. Not only should training programmes be given to the new salesman, but his performance should be kept under continuing review. Both to assist in this review and, even more importantly, to guard customers against the consequences of

over-enthusiastic selling, procedures should be established to review all purchase orders obtained by salesmen. The purpose of this review would be to identify purchases which seem inappropriate for the purchasers concerned. Written confirmation of such purchases should be obtained from the purchaser, and they should be discussed with the salesman to ensure that he appreciates their implications.

14.47 The review of purchase orders we propose is an elaboration of a rule frequently called the "know-your-purchaser" rule. While we emphasize the role of the sales organization in the application of that rule, partial responsibility would inevitably be passed on to the salesman; in particular, he would have to obtain information concerning his customer on the basis of which the supporting staff could review the transaction. The review would not imply a "big brother" approach, under which purchasers would be arbitrarily limited to a certain type of investment deemed to be appropriate for them; if the purchaser fully understands the implications of an investment, he should be able to buy it regardless of whether it appears to conform to the normal standard for purchasers of his financial standing. On the other hand, where there is a significant deviation from the norm or where an investment seems inconsistent with prior investments of the same purchaser, it is reasonable to assume that he may not fully appreciate its implications and to consult again with him before the transaction is implemented. The classical example of such cases is the twenty-year contractual plan purchased by an octogenarian, but countless other examples could arise.

14.48 The "know-your-purchaser" rule is based on the principle that those engaged in the sale of securities to the public have a responsibility to ensure that the purchasers do not make investments which are plainly not desirable for them, or at least not without a full appreciation of the implications. The weight of the responsibility varies with the nature of the securities concerned; in the context of mutual funds, it is likely to be more onerous with most non-conventional funds than with most conventional funds. What is important is that the responsibility be accepted by the entire mutual fund in-

dustry, and not just by those sales organizations which presently have adequate supporting staff. Acceptance and implementation of this and the other responsibilities outlined in this section will result in great benefits to the public and, at least in the long term, to the mutual fund industry.

14.49 For the reasons set out in this section, we recommend:

(1) that the administrator should have authority to refuse an application for registration from, or to suspend the registration of, any sales organization if it becomes apparent that the organization lacks a staff adequate to carry out supporting and supervisory responsibilities. For this purpose, "sales organization" would include any organization which makes use of salesmen to sell shares or units of mutual funds, be it a broker, independent sales force or direct sales force; and

(2) that for purposes of recommendation (1) the supporting and supervisory responsibilities of a sales organization should include, but should not be limited to:

(a) the provision of expert assistance to salesmen so that adequate advice can be given to clients on technical matters beyond the scope of the salesmen's expertise, and the application of procedures designed to discourage salesmen from attempts to deal with such matters; and

(b) the application of procedures to obtain relevant information from purchasers of shares or units and to review that information in order to determine whether there is reason to believe the investment is inappropriate for the purchaser and, if that is the case, to obtain written confirmation from him before the transaction is proceeded with; such transactions should also be discussed with the salesmen concerned.

The Prospectus and Summary Prospectus

14.50 In paragraphs 14.07 and 14.08 we describe the importance we attach to information communicated to the purchaser by the salesman. If that information is not adequately integrated into the educational process designed

to result in effective competition, the process will almost certainly fail to succeed. We agree with the approach reflected by the existing regulatory structure, noted in paragraph 14.10, that the verbal content of the salesman's presentation cannot be effectively controlled and that emphasis must instead be placed on the documentation used. In that connection, it is necessary to distinguish between the prospectus and sales literature. The former is the document which must be filed with and accepted by the securities administrators in each province where sales are made; the latter includes all other material used in connection with the sales presentation, whether given to the proposed purchaser or merely shown to him. Traditionally, the former is a comparatively cumbersome and legalistic document which is little used in the sales process; the salesman's principal reliance in his attempts to persuade the customer is on sales literature and his verbal presentation.

14.51 The most significant defect in the application of the regulations which presently govern the sales process lies in the small use made of the prospectus. Ideally, it should play an important role in every sale made by a salesman. It should supply potential purchasers with complete information concerning the proposed investment in a comprehensible form. It should be received sufficiently early in the sales process to be of value in the investment decision. And it should be used by the purchaser. None of these ideals is presently attained. The principal reason for this, the cumbersome and legalistic nature of the document, is mentioned above. We are not critical of those responsible for the format of prospectuses; their difficulties result from the attempt to accomplish two objectives which are, in our opinion, irreconcilable. On the one hand, they are told to design the prospectus so as to provide important information in a succinct and lucid form for the benefit of the purchaser who lacks a complete understanding of mutual funds. On the other hand, they are told to provide extensive information, including legal and financial details, to the more knowledgeable purchaser. The two goals are both desirable, but they are irreconcilable through the use of a single document.

14.52 There is another reason why the use of prospectuses presently falls so far short of the ideal. This is the nature of the requirement for their delivery to purchasers. While a prospectus must be delivered to any purchaser of shares or units who acquires them (as is almost invariably the case) in the course of their primary distribution to the public, the delivery need not be effected until late in the sales process. In Quebec the prospectus need not be delivered until the time of confirmation of sale or of payment for the purchased securities. In the provinces west of Quebec, the prospectus must be sent or delivered to the purchaser prior to the agreement of purchase or within two days thereafter. Salesmen in practice deliver the prospectus only after the sale has been agreed upon; our observations indicate that this is attributable not to a desire to conceal information, but to the belief that a complicated and technical document might confuse the purchaser. The result is that purchasers do not usually have an effective opportunity to consider the prospectus before the decision to purchase is made.

14.53 The failure of the prospectus to satisfy its proper role leaves the field open for sales literature; this is particularly true since distribution companies have much greater freedom in the design and preparation of sales literature than is available to them with prospectuses. The controls applied to sales literature are minimal; a few securities administrators require that distribution companies file it with them, but none subjects it to review on a systematic basis. Apart from a rule of the Canadian Mutual Funds Association discussed in paragraph 14.77 which prohibits the use of comparative information, no guidelines exist except for general anti-fraud requirements. Some distribution companies have maintained a high standard of sales literature, but others have taken advantage of the lack of controls in this area to provide their salesmen with material that fails to put the information provided into its proper context, or is deficient in other respects. We comment on these problems at greater length in paragraphs 14.67 to 14.78, where we make specific proposals concerning the content of sales literature.

14.54 While implementation of the proposals in paragraphs 14.67 to 14.78 would significantly improve the quality of sales literature, we have concluded that the importance and value of the role of the prospectus in the sales process must be increased. If this is to be done, each of the problems referred to above must be resolved. The prospectus must be made less cumbersome and legalistic, and it must be delivered at a stage in the sales process when it will be of real value to the purchaser. It is convenient to consider the latter objective first, and to contrast the prevailing procedure in Canada, described in paragraph 14.52, with that required in the United States under the Securities Act of 1933. In Canada, the prospectus is usually delivered after the sale is actually made; under the 1933 Act, the prospectus must be given to the potential purchaser prior to or together with the first other piece of written material he receives in connection with the transaction. In other words, the prospectus is the first, or among the first, and not the last of the documents received by the purchaser.

14.55 In principle, we prefer the approach of the Securities Act of 1933 to the prevailing Canadian requirement for prospectus delivery. We understand that technical difficulties relating primarily to distributions of underwritten industrial securities prevented the adoption of the 1933 Act rule in Canada. Without commenting on these difficulties, we have concluded that they are not relevant to the case where the salesman initiates a solicitation to buy mutual fund shares or units, and that, subject to resolution of the problems concerning prospectus content, the 1933 Act rule should provide the basis for the applicable Canadian requirement. It does not require modification for application to unsolicited sales, because in such sales no document is delivered to the purchaser prior to the time of sale, so that it would ordinarily be possible to comply with the rule in such cases through delivery of a prospectus concurrently with the confirmation.

14.56 Only two modifications in the 1933 Act prospectus delivery requirement are, we think, necessary for its adaptation to the sale of mutual fund shares or units in Canada. The prospectus should be required to be delivered prior to or concurrently with any document given or shown by or on behalf

of a salesman to the purchaser. Under the 1933 Act rule, advertisements are restricted because the prospectus delivery requirement treats advertisements as documents received by the recipients; that would not be true under our proposal. On the other hand, the 1933 Act rule only requires that a prospectus be delivered prior to or together with the delivery of any other document; we would extend this to include the showing of any other document to the purchaser in connection with the proposed sale.

14.57 Our proposals concerning prospectus delivery leave unresolved the more serious question of prospectus content. The obvious way to improve the value of the prospectus in the educational process would be to simplify it. Here the irreconcilable goals noted in paragraph 14.51 must be considered. Simplification of the prospectus would not be possible unless the second of those goals, the provision of legal and financial information for the knowledgeable purchaser, were abandoned. Yet there is a role, and an important role, to be played by a document which contains such information. That is emphasized by our own conclusions as to prospectus content in Chapter XV and in Appendix "E"; the implementation of those conclusions might well lengthen the prospectus rather than shorten it. Some solution must be found other than the abandonment of the attempt to provide full information in the prospectus. It is clear that a solution is necessary; earlier delivery of the prospectus in its present form would be more likely to frighten than to enlighten the purchaser for whom mutual funds are unsought goods.

14.58 To assist us in our consideration of the role and content of prospectuses, we appointed a sub-committee of consultants composed of a former securities administrator, a mutual fund officer, and two lawyers with different backgrounds. This sub-committee unanimously recommended that a summary prospectus should be delivered at an early stage in the sales process, and that the requirement for delivery of the full prospectus should remain unchanged except that if the prospective purchaser requested the full prospectus the salesman should be required to deliver it forthwith. We adopt that recommendation; in our opinion, the combination of the summary prospectus and the

full prospectus permit each of the objectives described in paragraph 14.51 to be attained, although they are irreconcilable in a single document. Together, these prospectuses will meet the needs of the purchaser for whom mutual fund shares or units are unsought goods, as well as of the purchaser for whom they are shopping goods.

14.59 The summary prospectus is a novel concept in Canadian securities legislation, and its implications merit careful consideration. We have concluded that it should be filed with and reviewed in conjunction with the full prospectus of each mutual fund, but that it should not attract the statutory civil liabilities that are attendant on the full prospectus. Were the statutory liabilities to be applied, the size of the summary prospectus would soon equal that of the full prospectus, as lawyers strove to include all relevant information. Such a result would be completely inconsistent with the objectives of the requirement. The summary prospectus would contain a summary, in clear and readable form, of the portions of the full prospectus which are of greatest importance to purchasers. It would differ considerably between mutual funds, and its format and contents should be discussed between the administrator and the mutual fund organization. The following sample text is intended only to exemplify the type of document we envisage. It is based on a non-conventional fund as a more complicated situation; modifications would be necessary for conventional funds. A paragraph is included to exemplify the treatment of contractual plans, although under our proposals contractual plans would be prohibited for non-conventional funds.

SUMMARY PROSPECTUS

TO THE PURCHASER: THIS CONTAINS IMPORTANT

INFORMATION AND SHOULD BE CAREFULLY READ

ABC FUND, LTD.

(a non-conventional fund)

This document contains important information concerning ABC Fund, Ltd. (the "Fund"). Much more information is provided in the full prospectus, of which this is a summary. Cross-references are made to the page numbers in the full prospectus where more complete information is to be found. The representative or salesman who gives you this summary prospectus is required also to give you a copy of the full prospectus on request.

The purpose of the Fund, as of other mutual funds, is to enable you to invest in a diversified portfolio of investments. This is achieved through your purchase of shares; if you purchase on a lump sum basis, the money you pay, after deduction of __% for sales charges (unless you pay over $10,000, in which case the percentage is less) will be invested by the Fund. See below for a description of other methods of purchase.

Investment Objectives and Risk

It is important for you to realize that the Fund takes risks in the pursuit of maximum capital gains on a long-term basis; among the risks it assumes are those involved in investments in small companies without established earnings records. The fund is known as a non-conventional fund because it is permitted to, and often does, borrow money to invest. All of these practices may increase the degree of risk; while the acceptance of risk may improve gains made by the Fund, it may also result in losses. <u>You should not invest in this mutual fund with money you cannot afford to lose</u>. See page 4 of the full prospectus for a more complete description of investment objectives and practices.

Management and its Cost

The Fund has an agreement with ABC Services Ltd., which organized the Fund. Under the agreement, that company supervises and directs the investment of the assets of the Fund and recommends the investments to be purchased or sold. For these services the Fund pays a fee of .5% of its average total net assets per year to that company; in exchange, the Fund also receives office space, equipment and other administrative services. The Fund must pay its own legal and auditing fees, and for the preparation and mailing of annual reports. These costs have increased the total management expenses of the Fund, as a percentage of average total net assets, to .67%; .70%; .69%; .70%; and .71% for the years 1964, 1965, 1966, 1967 and 1968 respectively. In addition, brokerage fees and income taxes are also paid by the Fund; these are not included in the management expense. See page 6 of the full prospectus for more information on management costs.

Results for the Past Five Years

The following table shows the results of the mutual fund on a per share basis for the past five years.

[This table should be prepared in accordance with Table 15-D which appears after paragraph 15.54.]

In considering this table, and particularly in comparing the information it contains with similar information for other mutual funds, bear in mind the following:

(1) it may be misleading to assume that past investment results will be continued in the future;

(2) in 1966, the senior investment manager of the Fund's investment advisory company resigned and was replaced by his former assistant;

(3) the Fund is a non-conventional fund, and it would be misleading to compare its results with those of conventional funds or of other non-conventional funds with different investment objectives and practices, without making allowance for differences between them.

See pages 5 and 6 of the full prospectus for more information on these matters; detailed financial statements are provided on pages 8 to 10.

General Attributes of the Shares

By purchasing shares of the Fund, you will spread your risk of investment because of the diversification of the investments made by the Fund. In addition, you will obtain professional management of your investment. You should note, however, that the presence of professional management of your investment does not necessarily mean that it will increase in value; it could decrease in value and the nature of the investment objectives and practices makes it unlikely to be a stable investment. The value of your shares is directly dependent upon the market value of the investments of the Fund which may increase or decrease from day to day. Finally, you can readily convert your investment into cash because your shares are redeemable at any time, at your option, at their net asset value. In certain circumstances after a redemption you may repurchase shares of the same value without sales charges. On the other hand, if your purchase is of over $50,000 and you redeem within six months you will be subject to additional charges.

See pages 2 to 4 of the full prospectus for more information on these matters.

Tax Position and Dividend Policy

The Fund is taxed on the dividends it receives and on its other income at the ordinary rates for corporations under the Income Tax Act. While shareholders are entitled to deduct 20% of dividends received from their Canadian income tax, it is the Fund's policy to pay no dividends. Shareholders may be subject to a tax on a portion of the amount received on redemption as ordinary income. See pages 7 and 8 of the full prospectus for more information on taxes and dividend policy.

How You May Invest

You may invest in the Fund in any of the following ways. The method you choose should depend upon your personal investment needs.

Lump Sum Investments

You may invest a lump sum. The minimum amount is $300. The maximum sales charge, as mentioned above, is___% of the amount you pay; if you pay $10,000, ________ will be invested in the mutual fund. The sales charge rate is reduced on purchases over $10,000. See page 2 of the full prospectus for a table of sales charges.

Voluntary Plans

You may invest a sum of money now and plan to make future investments whenever you desire. The minimum amount of the first investment is $200. Subsequent investments, which may be made as frequently or infrequently as you wish, may be as low as $100 each. The maximum sales charge is___% of the amount invested. As with lump sum purchases,this sales charge is reduced as the total amount you invest increases. See page 3 of the full prospectus for more information.

Contractual Plans*

Under a contractual plan, you agree to invest an initial amount as low as $100 and subsequent regular monthly investments as low as $20.00. Such investments may be scheduled for 10 or 20 years depending on the plan. The sales charges and service fees for investment in this way total 11% of the amount to be invested under the plan, assuming completion of all payments.

Note that the costs are not deducted at the same rate from each payment. Between 30% and 32% of the first thirteen payments are used to pay sales charges and service fees. Hence, it is obvious that less than 70% of the first thirteen payments is utilized for the purchase of shares. Sales charges and service fees deducted from subsequent investments are substantially less. Cancellation of your plan in its early stages will almost invariably result in a loss to you; the plan must be completed if the percentage deducted as sales charges and service fees is to be minimized. For these reasons, it is important for you to consider seriously your financial position and your ability to complete the plan before you commence it.

See page 3 of the full prospectus for more information on contractual plans.

Regular Withdrawal Plans

The regular withdrawal plan is designed to provide the investor with a stated amount of money on a regular basis.

The plan requires an initial minimum investment of $1,000. The maximum sales charge is___% of the amount invested. This is a lump sum investment and the comments above concerning these investments apply here.

Each month or at other regular intervals the Fund will pay you a stated amount of money. This money will be paid out of your investment in the Fund, the value of which will increase or decrease in accordance with the market value of the investments of the Fund and will increase by the net income earned by the Fund.

The Fund will continue to make payments to you only as long as you continue to have an investment in the Fund. Such payments are not made for a guaranteed period. The prices of securities rise and fall periodically. Because of the hazards of adverse market fluctuations, you should exercise particular care

* This section is included for illustrative purposes despite the fact that shares or units of non-conventional funds could not be sold by contractual plans.

in selecting amounts for withdrawal. Such withdrawals should be consistent with your financial position and needs.

The salesman or representative who gives you this document may explain the advantage of dollar cost averaging in the purchase of shares. Before arranging a regular withdrawal plan, you should consider the fact that with such plans dollar cost averaging works in reverse; more shares are redeemed to make payments when the market is low in price. See page 4 of the prospectus for more information on regular withdrawal plans.

14.60 Delivery of the summary prospectus should be made to the proposed purchaser in compliance with the requirements outlined in paragraphs 14.55 and 14.56, except that in cases where delivery need not be made pursuant to those requirements until after completion of the sale, the full prospectus could be delivered instead. This exception would operate to exempt unsolicited purchases from the requirement for delivery of the summary prospectus, an appropriate result since the unsolicited purchaser will ordinarily be one for whom mutual funds are shopping goods. In all other cases, the summary prospectus should facilitate the communication of important information to proposed purchasers. The cross-references to the full prospectus contained in the summary prospectus should increase the extent of use of the latter document. We have considered whether the full prospectus should be delivered at or before the time of confirmation of sale in all cases, regardless of whether the summary prospectus had previously been delivered. Our conclusion is that the full prospectus should be delivered except in cases where the purchaser specifically waives it by signing a declaration to that effect either affixed to his purchase order, or as a separate document signed at the same time. The declaration should state that he has reviewed the summary prospectus and does not require delivery of the full prospectus. The availability of this procedure should result in a saving to distribution companies which take advantage of it, while effectively drawing the availability of the full prospectus to the attention of the purchaser. Delivery of the full prospectus would, of course, be required in cases where no summary prospectus was delivered because of the availability of the exception for unsolicited orders.

14.61 For the reasons set out in this section, we recommend:

(1) that the prospectus delivery requirement referred to in the following recommendations should be a requirement for delivery of a prospectus or summary prospectus prior to or concurrently with the time that the first other written document is delivered or shown to the purchaser or proposed purchaser by or on behalf of the salesman; for purposes of this requirement, generally circulated advertising not specifically designed for the purchaser or delivered to him by or on behalf of the salesman would not be considered to be a written document delivered to the purchaser;

(2) that there should be filed, together with each prospectus for mutual fund shares or units, a summary of the full prospectus which should briefly set out the most important information to the purchaser that is contained in the full prospectus with cross-references to pages in the full prospectus where more complete information can be found;

(3) that the summary prospectus should be reviewed and accepted by the appropriate administrator according to a procedure similar to that followed with the full prospectus, but that statutory civil liabilities similar to those which relate to the full prospectus should not arise from the failure to provide complete information in the summary prospectus;

(4) that the summary prospectus should be delivered in compliance with the prospectus delivery requirement proposed in recommendation (1), except that in cases where the delivery would not be required until after the time of sale the full prospectus could be delivered instead;

(5) that the salesman who delivers a summary prospectus pursuant to recommendation (4) should be required to supply the potential purchaser with a full prospectus forthwith on demand by the potential purchaser; and

(6) that delivery of the full prospectus should be made at or before the time of confirmation of sale in all cases, regardless of prior delivery

of the summary prospectus, except to any purchaser who satisfies both of the following conditions:

(a) he has received a summary prospectus in compliance with recommendation (4); and

(b) he has signed a declaration either affixed to the purchase order or as a separate document signed concurrently with the purchase order, which declaration states that he has reviewed the summary prospectus and does not require delivery of the full prospectus.

Content of the Prospectus

14.62 Our conclusion in the preceding section that summary prospectuses should be made part of the regulatory scheme applicable to mutual funds is based largely on our belief, expressed in paragraph 14.51, that the full prospectus cannot be made into a succinct and lucid document if it must contain the detailed information necessary for the knowledgeable purchaser. We arrived at this conclusion with considerable regret, and only after a careful analysis of alternatives. It was largely dictated by the number of instances throughout this report in which we concluded that certain information should be disclosed in prospectuses. For the convenience of the reader, the recommendations, other than those which relate to financial disclosure, are summarized in Appendix "E". Our conclusions as to financial disclosure are set out in Chapter XV.

14.63 Appendix "E" contains comparative references to Form 12 under The Securities Act, 1966 (Ontario). Form 12 sets out the content of a mutual fund prospectus under that Act, and has been adopted with minor changes in the Western provinces. We have concluded that it should be adopted nationally, subject to the changes proposed in Appendix "E" and to the recommendations on financial disclosure in Chapter XV. While Appendix "E" contains a number of specific recommendations in addition to a summary of those made in the text of the report, it does not represent the results of a complete review of Form 12. That form became effective only in 1967, and represented the results of careful analysis at that time. We have confined our comments con-

cerning it to specific questions which arose in the course of our work; a complete review and reconsideration of Form 12 should await the results of further experience under the form as it is at present, with the changes we propose.

14.64 The conclusion that prospectuses cannot successfully be transformed into simple and readable documents is not intended to imply that no attempt should be made to simplify them or to make them more attractive to readers. The development of the narrative prospectus has been a substantial step in this direction, and further such steps should be encouraged. In addition, flexibility should be provided so that the prospectus can be made into an attractive sales document. With this objective, it should be permissible to include any material which would be acceptable under the guidelines for sales literature prepared in accordance with the proposals in the following section. Distribution companies should be encouraged to make use of the prospectus as sales literature so far as possible consistent with applicable legal requirements.

14.65 Mutual funds which invest exclusively in the shares or units of a single other mutual fund require special consideration. Such mutual funds would be exempted from the restrictions applicable to funds on funds, under the proposal in paragraph 12.90. The arrangement whereby one mutual fund invests exclusively in the shares or units of another mutual fund is sometimes adopted to provide the purchaser with a selection between a dividend-distributing and an income-accumulating mutual fund on the basis of a single investment portfolio, and is sometimes adopted in view of income tax or other considerations to provide for the indirect investment by Canadians in shares or units of a United States or other foreign mutual fund. Regardless of the reasons for the arrangement, we have concluded that the prospectus of the mutual fund which invests exclusively in shares or units of a single other mutual fund should include full information concerning the latter, and concerning the income tax and other consequences of this method of investment. Comments on financial disclosure in these situations are made in paragraphs 15.70 to 15.72.

14.66 For the reasons set out in this section, we recommend:

(1) that, subject to the changes which would result from the adoption of the recommendations in this report, Form 12 under The Securities Act, 1966 (Ontario) should be adopted nationally to govern disclosure requirements in mutual fund prospectuses; the proposed changes in Form 12 other than those consequent upon the recommendations in Chapter XV, are summarized in Appendix "E";

(2) that Form 12, as modified in accordance with recommendation (1), should be reviewed and revised after there has been adequate experience under it in practice;

(3) that the content of the prospectus should not be restricted to the material it is required to contain, but it should be permitted to include other material which conforms to the guidelines for the content of sales literature developed in compliance with paragraph 14.79; and

(4) that when a mutual fund is organized to invest exclusively in the shares or units of a single other mutual fund, the prospectus of the former mutual fund should include full information concerning the latter mutual fund and concerning the income tax and other consequences of this method of investment.

Content of Sales Literature and Advertising

14.67 While we anticipate that implementation of the proposals made in the preceding section will substantially increase the importance of the role played by the prospectus, we recognize that sales literature and advertising will continue to be the material principally relied upon by distribution companies. Here, and throughout this chapter, we use the term "sales literature" to refer to any material (other than the prospectus and summary prospectus) designed for use in the presentation to a purchaser whether it is given to him or only shown to him; it would include not only the conventional printed material but also such devices as the record or the video-tape played to the

client. We use the term "advertising" to refer to material generally disseminated through the communications media, including television and radio commercials as well as newspaper and magazine advertisements.

14.68 The extent to which the content of sales literature and advertising should be controlled by regulatory requirements is one of the most controversial aspects of regulation of the securities industry. Few, if any, participants in the industry would contend that there should be no restrictions; at the very least, false, misleading or deceptive statements included in sales literature should be prohibited. On the other hand, it has been strongly argued that any sales literature should be permitted provided that it does not contain material which is false, misleading or deceptive. We regard this discussion and the decisions made on the basis of it as of great importance, because this material, particularly sales literature, in many cases provides the information upon which the purchaser relies to formulate his investment decision. The impression given by sales literature can far outweigh the effect of statements made in the prospectus, and may also outweigh the summary prospectus.

14.69 In our consideration of the appropriate regulatory approach to advertising and sales literature, we have been well aware of the conflict to which regulatory authorities are always subject in this area. From one point of view, it might seem desirable to require that advertising and sales literature be integrated within the regulatory scheme evolved to encourage disclosure of relevant information, and be treated in a way similar to the prospectus. On the other hand, to adopt that approach could constitute a major intervention in the free operation of the industry and would be almost certain to put it at a competitive disadvantage. Particularly in view of our conclusions concerning summary prospectuses, we have concluded that the latter considerations should be given greater weight; it is important to allow the mutual fund industry the maximum flexibility in the creation of attractive and appealing advertising and sales literature. Our only major exception to this conclusion relates to non-conventional funds and is discussed in paragraph 14.77.

14.70 The decision that advertising and sales literature should not be treated in the same way as the prospectus is not alone sufficient to permit precise conclusions on whether a simple prohibition of false, deceptive or misleading material is enough, or more detailed restrictions are required. To assist us in these conclusions, we obtained from distribution companies copies of their sales literature in current use, and we have studied both this material and newspaper advertisements; the restrictions applied by the Canadian Radio-Television Commission, noted in paragraph 10.39, have to date prevented advertising for mutual funds on those media. In our studies of advertising and sales literature, we have noted a number of practices that cause us concern. Some of these are prevalent, while others appear infrequently, but all can convey a false impression to the reader who is not knowledgeable on financial matters, and sometimes even to the knowledgeable reader. The following are examples of the practices we have in mind:

(a) the use of rate of return comparisons with stock exchange and other indices, based on dates which are apparently deliberately selected to show the mutual fund to best advantage; in some cases where a single piece of sales literature is used for associated mutual funds, the comparisons for the several mutual funds are based on different starting dates apparently for no reason other than to show each mutual fund as favourably as possible;

(b) only rarely does sales literature which includes a comparison with an index include an adequate qualification concerning the relevance of investment practices or objectives, or other appropriate qualifications;

(c) historical records of rate of return often refer to very short periods; in some cases great emphasis is given to rate of return over a two or three month period, although such a period does not provide sufficient information upon which to assess the quality of investment management;

(d) in a number of cases management companies have organized and operated mutual funds for a period of time before the beginning of the sale of

their shares or units to the public, and have then given prominence to their rates of return attained during this "incubation" period; such a practice is deceptive because of the different constraints applicable to investment managers before and after public sale commences, and because the management company could organize several mutual funds and "go public" only with the one which attained the highest rate of return;

(e) in many cases, estimates and historical statements refer to a specified amount invested, and do not make clear that sales charges would have to be paid in addition;

(f) sales literature for mutual funds which have experienced a change in investment management often fails to refer to that change in historical statements of rate of return;

(g) generally, historical statements of rate of return are often not properly qualified by a statement that it may be inappropriate to rely on them for predictions as to future rate of return;

(h) special features of the investment objectives and practices of the mutual fund are often not emphasized; and

(i) implications are made, apart from the historical records, that a high rate of return will be continued into the future.

This list is intended only to exemplify the type of defects which concern us. In particular cases, many other problems appear. A complete statement of all the possible problems would be impossible, particularly since it is the over-all impression which is important and statements that are innocuous in themselves may sometimes be combined to lead to a misleading impression on the part of the reader.

14.71 We have concluded that a prohibition of false, misleading or deceptive statements would be inadequate as a control over advertising and sales literature. The line between acceptable and unacceptable material under

such a vague test is so much a matter of judgment as to make the test almost worthless except in the most flagrant cases. More precise guidelines are required; the problem cannot be adequately resolved through the obvious expedient of a requirement that all advertising and sales literature be filed with and approved by the appropriate administrator prior to its use. The sheer volume of material involved would be sufficient to overwhelm even a large staff, and the problems of judgment to be made on such a large volume of material would tax a Solomon. It would, however, be desirable for the administrator to have authority to require a named person or company to file with him all sales literature and advertising material at least seven days prior to its use. This power would provide a method to deal with the organization suspected of making use of improper material.

14.72 The best remedy for the problems associated with advertising and sales literature would be found through the effective application of self-regulation within the mutual fund industry. In paragraphs 19.23 to 19.35 we discuss the present status of self-regulation, and describe what we consider to be the preconditions to effective self-regulation. It is unrealistic to expect that such preconditions will be satisfied in the immediate future, and until they are satisfied it will be necessary for the administrator to pass on questions of what is and what is not appropriate in advertising and sales literature. Without reviewing all such material, he should be prepared to take appropriate action when deficient material comes to his attention.

14.73 Regardless of whether the administration is performed by a governmental agency or by a self-regulatory industry association, we have concluded that guidelines are necessary to reduce the extent to which decisions will be matters of individual judgement. We are cognizant in this connection of the point made in paragraph 14.69 that maximum flexibility should be allowed for the creation of attractive and appealing advertising and sales literature. For that reason, the guidelines should be as liberal as possible, but they must embody appropriate restrictions to prevent practices such as are listed in paragraph 14.70. In the United States, the Securities and Exchange Commission in

conjunction with the National Association of Securities Dealers has prepared a Statement of Policy which is administered by the N.A.S.D. subject to a right of review in the S.E.C. We have studied the Statement, and have found that it deals with all the problems of concern to us, and a number of other problems which we have not noted in our study of advertising and sales literature but which should be encompassed within a set of guidelines. The requirements of the Statement may, however, be somewhat more restrictive than is necessary in the Canadian context.

14.74 In keeping with our belief that this is an area peculiarly appropriate for industry self-regulation, we have not attempted to design modifications which would adapt the S.E.C.-N.A.S.D. Statement of Policy for Canadian application. Any such modifications should, in our opinion, be prepared by representatives of the mutual fund industry in consultation with the administrators. The preparation should be commenced as a matter of urgency as soon as possible after publication of this report; the S.E.C.-N.A.S.D. policy ruling should be adopted if it becomes apparent that the mutual fund industry will not be successful in the preparation of appropriate modifications.

14.75 Exclusive reliance should not be placed on the Canadian Mutual Funds Association to represent the mutual fund industry in the modifications contemplated by the preceding paragraph. For reasons indicated in paragraph 19.28 we do not consider the C.M.F.A. to be fully representative of the Canadian mutual fund industry. It should, of course, be represented, but independent sales forces, brokers and mutual funds not members of the C.M.F.A., including trust company investment funds and United States mutual funds selling in Canada should also be represented. A group established with this representation might well have the incidental beneficial effect of contributing to the long-term improvement of relationships among participants in the Canadian mutual fund industry.

14.76 In the formulation of guidelines for application to mutual fund advertising and sales literature used in Canada, one restriction should be avoided. The Code of Ethics of the Canadian Mutual Funds Association con-

tains provision that

> The making of comparisons with other mutual funds in sales literature, charts or mailing pieces is prohibited.

In our opinion, this is an unnecessary restriction on competition. If one mutual fund is in fact superior to another, it should be permitted to say so. It could be contended that to permit such comparisons would result in a further increase in the emphasis on rate of return, but the guidelines applied in accordance with the conclusions in preceding paragraphs should contain provisions which would restrict such emphasis. It would, in our opinion, be in the public interest to permit distribution companies to make use of advertising and sales literature to point out differences in management fees or sales charges, or a prolonged difference in rate of return. The S.E.C.-N.A.S.D. guidelines contain restrictions designed to avoid abuses in this type of comparison, and similar restrictions should be included in guidelines for Canadian use.

14.77 In order to implement the general policy that non-conventional funds should not be sold to purchasers for whom they are unsought goods, we have concluded that more rigorous restrictions should be applied to advertising on behalf of such mutual funds. The content of their advertisements (but not of their sales literature) should be restricted to the name of the mutual fund concerned; an address from which further information may be obtained (a telephone number should also be permissible); the name of its management company; a brief statement of its investment objectives and practices; and the most recent offering price (net asset value per share or unit plus applicable sales charges). This restriction is not unduly onerous, since many mutual fund advertisements contain only that much information even without the restriction, and it would prevent the sale by advertising of non-conventional funds on the basis of rate of return.

14.78 In spite of our recognition of the fact that the principal focus of attention in the salesman-purchaser flow of information must be on the material used, we have concluded that the salesman should be prohibited from the use of information verbally which would not be permissible if used in writing.

He should therefore not be permitted to include in his oral presentation any material that would be prohibited from advertising and sales literature under the proposed guidelines. Because of the problems of proof involved, breaches of this requirement should not result in civil liability unless the statements made amounted to fraud. They should, however, subject the salesman to discipline by his own sales organization or by the appropriate administrator.

14.79 For the reasons set out in this section, we recommend:

(1) that for the purposes of the following recommendations, the term "sales literature" includes all material (other than prospectuses and summary prospectuses) designed for use in the presentation to a purchaser, whether it is given to him or shown to him, and includes records, video-tape and similar material as well as written matter; "advertising" includes all sales material generally disseminated through the communications media, including television and radio commercials as well as newspaper and magazine advertisements;

(2) that the administrator should have authority to require any named person or company to file with him copies of all advertising and sales literature to be used by such person or company at least seven days prior to its use;

(3) that, apart from cases where requirements are imposed under recommendation (2), administrators should not review advertising and sales literature in order to approve such material; they should, however, be prepared to take appropriate disciplinary steps when unsatisfactory material comes to their attention, but should delegate this responsibility to the maximum feasible extent to any effective self-regulatory body which may develop;

(4) that guidelines should be prepared upon the basis of which decisions may be made concerning the adequacy of advertising and sales literature; such guidelines should be based upon the Statement of Policy formulated in the United States by the Securities and Exchange Commission and the

National Association of Securities Dealers Inc., but should contain appropriate modifications proposed by representatives of the Canadian mutual fund industry working with the administrators;

(5) that the modifications referred to in recommendation (4) should be prepared as soon as possible after publication of this report by a group which should include representatives of all affected segments of the Canadian mutual fund industry;

(6) that if it becomes apparent that the group referred to in recommendation (5) will not be successful in the expeditious preparation of appropriate modifications, the guidelines adopted should be the same as those in the S.E.C.-N.A.S.D. Statement of Policy referred to in recommendation (4);

(7) that the guidelines adopted should permit comparisons among mutual funds subject to appropriate restrictions;

(8) that advertising, but not sales literature, of non-conventional funds should be restricted to the following content:
   (a) the name of the non-conventional fund;
   (b) an address from which further information may be obtained; a telephone number should also be permissible;
   (c) the name of the management company of the non-conventional fund;
   (d) a brief statement of the investment objectives and practices of the non-conventional fund; and
   (e) the most current offering price of shares or units of the non-conventional fund; and

(9) that salesmen should be prohibited from making, in their oral presentations, statements the inclusion of which in sales literature would be prohibited under the guidelines; unless the statements made are fraudulent, violation of this prohibition should not result in a statutory civil liability, but should subject the salesman to disciplinary proceedings.

Calling on Residences and "Switching"

14.80 A number of aspects of salesmen's activities which are only indirectly related to disclosure made to potential purchasers have attracted legislative attention in Canada. Perhaps the most controversial of these is the practice of calling on residences. Most of the provinces prohibit securities salesmen from telephoning or visiting the residences of potential purchasers in order to solicit sales. All provide for exceptions from this prohibition, although the exceptions differ between provinces. Those contained in section 67(2) of The Securities Act, 1966 (Ontario) are typical. That section permits calls on the residences of close personal friends, business associates, and persons on whose behalf the salesman has been in the habit of trading in securities. It also permits calls at the residences of persons who have requested in writing that information be supplied to them with respect to the security being sold.

14.81 The prohibition against calls on residences is strongly opposed by many securities salesmen, but particularly by those who sell mutual fund shares or units. The latter contend that the prohibition puts them at a competitive disadvantage by comparison with life insurance salesmen, who are subject to no such prohibition. The arguments against the prohibition have been recognized in some provinces, which have modified it for all securities salesmen without specific reference to mutual fund salesmen. In Alberta and New Brunswick, the prohibition is only operative when the administrator determines by order that it should apply to a specified person or company. In Manitoba, an exception is provided for telephone calls that are solely for the purpose of making an appointment.

14.82 The purpose of the prohibition against calls on residences is, presumably, to prevent persons from being troubled at home by unsolicited calls from securities salesmen. The historical antecedent of the section is a provision added in 1928 to the Companies Act of England, which prohibited any person from going from house to house offering shares for subscription. That provision was adopted pursuant to a recommendation of a Committee of the

Board of Trade.* The Committee made the recommendation as an alternative to the licensing of salesmen, which it specifically rejected. The section has been carried on in modified form from that time, but since the adoption of licensing requirements in England it has not received the degree of importance in that country which it has in Canada. Without expressing any opinion as to the desirability of the prohibition in its application to other types of securities, we have concluded that it is unnecessarily rigorous in the context of mutual funds.

14.83 One reason for our conclusion as to the prohibition of calls on residences is that it is difficult or impossible to enforce adequately. This is clearly shown by experience of the various securities commissions. In addition, our observations indicate that many mutual fund salesmen ignore the prohibition, and few of them are ever reprimanded for doing so. Another factor which has influenced our decision is that no similar prohibition is applied to salesmen of life insurance or of investment contracts, yet complaints are rarely heard from persons who are called at home by these salesmen. In addition, it is important that the section was evolved largely to deal with the "hawking" of highly speculative securities, and very few mutual funds are speculative securities within the intent of the original prohibition.

14.84 The reasons for our conclusion that a general prohibition of calls on residences is unnecessary, as set out in the preceding paragraph, are supported by a further reason which relates to the impact on the sales process of such a prohibition. It involves the danger that salesmen will be prevented from effecting sales outside the narrow circle of their family and friends. This could increase salesman turnover and reduce the degree of long-term commitment felt by salesmen. In addition, it could lessen the effectiveness of competition among sales forces. We have reached no conclusion as to whether these consequences in fact result at present from the prohibition, although it is of interest that 56.1% of contractual planholders and 59.0% of lump sum purchasers interviewed in our consumer survey reported that the salesman was a relative, friend or acquaintance. Whether or not the prohibition in fact increases turnover, it could well have that result; if it did, its effect would be harmful rather than helpful.

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* Board of Trade Departmental Committee on Company Law Amendment (London, 1925-26); Command Paper 2657.

14.85 While we have concluded that the prohibition against calls on residences as it applies to mutual fund salesmen should be abandoned in favour of emphasis on supervision over salesmen and other controls proposed in this chapter, we think that it may be helpful in some circumstances for the appropriate administrator to have authority to order that the prohibition be made applicable to a specified person or company, or to require compliance by a person or company with certain conditions if it is to have the continued benefit of the exemption. This is the approach adopted in Alberta, and we have concluded that it should be made of general application. It will provide an effective method to deal with any instance in which a salesman or sales organization abuses the privilege of calling on residences. The power of prohibition will, we trust, be sparingly exercised, for the salesman subject to such a prohibition will be put at a significant competitive disadvantage.

14.86 Another area of concern with sales techniques is the practice commonly known as "twisting" or "switching". The former expression is commonly used in the context of life insurance, and the latter expression in the context of mutual funds. Each expression refers to attempts by salesmen to persuade clients to sell, redeem or cancel their arrangements with other organizations in order to effect a purchase from the salesman, usually with a resultant duplication of sales charges. Twisting, in the context of life insurance, is prohibited by statute in the legislation of the provinces. Switching, in the context of mutual funds, is disapproved by most sales organizations and is subject to a specific prohibition in the code of ethics of the Canadian Mutual Funds Association, but is not prohibited by statute. We have had submissions made to us, particularly by the Life Underwriters Association of Canada, that a statutory prohibition should be enacted which would extend to cases where the salesman persuades the client to terminate life insurance in order to buy mutual funds, or the reverse.

14.87 We recognize that twisting or switching is an abuse in most cases, for the client is penalized in sales charges without a commensurate increase in the quality of his investment. However, cases can readily be envisaged in which the client would benefit from a liquidation of one investment

and its transfer to another even at the expense of a duplication of sales charges. This is particularly true of a transfer between equity instruments or between an equity instrument and a debt instrument (or the reverse). We therefore do not feel that a prohibition of twisting or switching is appropriate. Instead, we have concluded that a salesman should be subject to suspension in any case where, in a transaction involving mutual fund shares or units, he persuades a client to liquidate an investment to purchase another investment with consequent duplication of sales charges, unless he can establish that he first fully advised the client on all the implications of the proposed transaction. This should be one of the matters considered by the staff of the sales organization in its review of transactions in accordance with the suggestions in paragraphs 14.46 to 14.48.

14.88 Calls on residences and twisting or switching are only two of a host of sales practices the merits of which are the subject of controversy. We have concluded that it is not feasible to attempt a complete review of all such practices; it is true of most of them, as of the two considered in this section, that their merits vary from case to case. Only a sense of proper business conduct and a high ethical standard on the part of the individual salesman, and support from a staff with similar standards, can effectively avoid improper sales practices. We have concluded that the existing regulations applicable to salesmen and sales practices are adequate and should be preserved. The administrator should continue to have authority to deal with alleged improprieties on a case-by-case basis.

14.89 For the reasons set out in this section, we recommend:

(1) that the prohibitions against calling on residences imposed by the securities legislation of most provinces should be made inapplicable to salesmen who call in order to sell mutual fund shares or units; provided that the appropriate administrator should have authority (which should be sparingly exercised) to apply the prohibition to a specified person or company and should also have authority to make the continued availability of the exemption to a person or company subject to compliance by it with specified conditions;

(2) that a salesman should be subject to suspension in any case where, in a transaction involving mutual fund shares or units, he persuades a client to liquidate an investment in order to purchase another investment with consequent duplication of sales charges, unless the salesman can establish that he first fully advised the client on all the implications of the proposed transaction;

(3) that the review procedure recommended in paragraph 14.49, recommendation (2), clause (b), should be so designed as to detect transactions of the type described in recommendation (2) and to determine whether they are appropriate for the purchaser; and

(4) that, except to the extent that changes are required to implement the above recommendations and other recommendations in this report, the existing regulations applicable to salesmen should be preserved, including the power of the administrator to deal with problems on a case-by-case basis.

Confirmation of Purchases

14.90 The confirmation mailed to the purchaser of shares or units following the transaction is of considerable importance to the sales process, for it provides him with his written record of the relevant facts concerning the purchase. Its importance will be accentuated by the implementation of the proposals made in the following section, where we suggest that the time of receipt of the confirmation should be determinative of the period during which rescission rights will be available. The practices followed in the confirmation of purchases at present vary considerably. Brokers ordinarily provide their clients with information similar to that required to be provided on confirmations for securities traded in the secondary markets. Distribution companies and independent sales forces usually send the purchaser a document which sets out the purchase price and indicates (often to the fifth place of decimals) the number of shares or units acquired. In most, but not all, cases the confirmation also indicates the price per share or unit at which the investment is made. Information supplied concerning purchases under contractual plans is similar.

14.91 We have concluded that it is desirable to specify the minimum amount of information which must be provided to the purchaser of mutual fund shares or units in a confirmation of his transaction. Similar requirements have long been applied to brokers, and their existence prevents the temptation which might otherwise exist to mask the portion of the purchaser's payment deducted for sales charges or commissions. The latter point is of particular importance in the context of mutual fund shares or units, since their quoted prices include sales charges, and the sales charges are determined as a percentage of the amount paid by the purchaser rather than as a percentage of the amount actually invested. While, for reasons indicated in paragraphs 10.41 to 10.44, we approve of the continuance of this practice, it may sometimes prevent the purchaser from a full appreciation of the impact of sales charges. The requirements as to confirmations which we propose should avoid this consequence, and the rescission rights proposed in the following section will enable the purchaser to rescind the transaction if he decides against it in light of the information contained in the confirmation.

14.92 The differences between purchases under contractual plans and those made on a lump sum basis necessitate separate treatment of the two. As to lump sum purchases, we have concluded that the sales organization concerned - broker, independent sales force or distribution company - should be required to send or deliver, promptly, a confirmation which provides at least the following information:

(a) the amount paid by the purchaser;

(b) the amount deducted by way of sales charges or service fees and, separately stated, any other deductions;

(c) the price per share or unit at which the purchase was effected; and

(d) the number of shares or units purchased.

The confirmation should also state the name of the salesman, if any, concerned in the transaction. Corresponding requirements applicable to other types of securities transactions in several provinces permit the use of an identifying

number for the salesman, if the customer can obtain his name on demand. We have concluded that, in view of the long-term nature of the commitment involved in the purchase of mutual fund shares or units, and the importance to the customer of adequate service from the salesman, this alternative should not be available and the name should be included on the confirmation.

14.93 With purchases made under contractual plans, we think it necessary to distinguish between the confirmation of the initial payment and the confirmations of subsequent payments. In paragraphs 2.25 and 2.26 we describe the differences between traditional contractual plans and prepaid sales charge contractual plans, and we distinguish between them in the conclusions reached in paragraphs 10.94 to 10.124. The confirmation of the initial payment made under a traditional contractual plan should include all the information listed in the preceding paragraph. It should also include a brief explanation, suitable for subsequent reference by the purchaser, of the manner in which sales charges are to be deducted from subsequent purchases. The confirmation for the initial payment under a prepaid sales charge contractual plan should indicate the amount paid, and should clearly specify that no portion thereof has yet been invested on behalf of the purchaser. It should contain an explanation of the deductions to be made from subsequent payments similar to the explanation required with front-end load contractual plans, but the explanation should also deal with the manner in which the initial payment is to be allocated to investments in the mutual fund.

14.94 With both types of contractual plans, the purchaser should receive a confirmation for each payment after the initial payment that would contain, in addition to the information contemplated by paragraph 14.93, a statement of the total number of shares or units acquired under the plan up to and including the current payment. This will assist the purchaser in his understanding of the status of his investment. In the case of prepaid sales charge contractual plans, the confirmations for subsequent payments should also indicate the status of the initial payment and the portion thereof allocated to the payment with respect to which the confirmation is sent.

14.95 In paragraph 14.104 we conclude that, for purposes of the application of rescission rights, periodic payment plans which are subject to a termination fee in excess of ordinary sales charges should be treated as contractual plans. In order to permit the purchaser to understand the implications of such plans, the confirmation of the initial payment should include a clear statement of the termination fee and of the circumstances in which it will be imposed.

14.96 For the reasons set out in this section, we recommend:

(1) that the sales organization - broker, independent sales force, or distribution company - which effects a sale of mutual fund shares or units on a lump sum basis should be required to send or deliver to the purchaser, promptly, a confirmation which contains at least the following information:

(a) the amount paid by the purchaser;

(b) the amount deducted by way of sales charges or service fees and, separately stated, any other deductions;

(c) the price per share or unit at which the purchase was effected;

(d) the number of shares or units purchased; and

(e) the name of the salesman, if any, concerned in the transaction;

(2) that the sales organization which effects a sale of mutual fund shares or units on the basis of a traditional contractual plan of the type contemplated by paragraph 10.125, recommendation (3) should be required to send or deliver to the purchaser, promptly, a confirmation of the initial payment which should include all the information contemplated by recommendation (1) and should also include a brief explanation, suitable for subsequent reference by the purchaser, of the amounts of sales charges to be deducted from subsequent purchases;

(3) that the sales organization which effects a sale of mutual fund shares or units on the basis of a prepaid sales charge contractual plan of the type contemplated by paragraph 10.125, recommendation (4) should be required to send or deliver to the purchaser, promptly, a confirmation

of the initial payment which should contain all the information contemplated by recommendation (2) and should also explain how the initial investment is to be allocated to subsequent investments in the mutual fund;

(4) that the sales organization which effects a sale of mutual fund shares or units on the basis of a periodic payment plan subject to a redemption fee should be required to send or deliver to the purchaser, promptly, a confirmation of the initial payment which should include all of the information contemplated by recommendation (1) and should also include a clear statement of the termination fee and of the circumstances in which it will be imposed; and

(5) that the organizations referred to in recommendations (2), (3) and (4) should be required to send or deliver to the purchaser, promptly, a confirmation of each payment made under a contractual plan after the initial payment; such a confirmation should include the information contemplated by recommendation (1) and should also include a statement of the total number of shares or units acquired under the contractual plan to that time; in addition, the confirmation for each payment after the initial payment on a prepaid sales charge contractual plan should indicate the status of the initial payment and the portion thereof allocated to the payment with respect to which the confirmation is prepared.

Rescission Rights

14.97 It is obviously desirable for the investor to give serious consideration to his investment decision. Yet, as Table II-D (which appears after paragraph 2.43) indicates, more than half of those interviewed in our consumer survey made their investment decision in the course of the first interview with a salesman. This tendency of purchasers to make up their minds quickly, perhaps without taking all the relevant facts fully into account and perhaps when subject to the enthusiasm conveyed by an expert salesman, has long been of concern to legislators. The concern applies not only to mutual funds but also

to other securities and to consumer goods sold by sales forces. In an attempt to provide an opportunity for sober second thoughts, reliance is increasingly placed on rescission rights. The rescission of a transaction, technically, involves the restoration of each party thereto to his original position, as if the transaction had not taken place. However, when rescission is effected pursuant to a statute the provisions of the statute determine the precise nature of the remedy. The theory which underlies rescission rights as part of the regulatory scheme applicable to sales made by salesmen is that to grant to the purchaser the legal right to demand that his transaction be rescinded within a specified period after its implementation, will provide him with a meaningful opportunity to reconsider the original decision.

14.98 Rescission is presently available as of right to Canadian mutual fund investors in two principal situations; in addition, distribution companies sometimes grant rescission on a voluntary basis to dissatisfied purchasers who have no legal right to demand rescission. The first type of rescission available as of right arises under the applicable securities legislation of Ontario and the Western provinces, except British Columbia, and is integrated with the requirement of prospectus delivery. The purchaser has the right to rescind the purchase within two business days after receipt by the purchaser of the prospectus; if the prospectus is received two or more business days prior to the purchase, he has no rescission right after the purchase. This arrangement is designed to provide an opportunity to consider the contents of the prospectus before becoming bound by the transaction. It is available to mutual fund purchasers in common with other purchasers of securities in the course of primary distribution to the public.

14.99 The second situation in which rescission is available to Canadian mutual fund investors as of right is the 30-day right provided to purchasers of contractual plans. This right is not available by statute, but as a result of a self-regulatory requirement of the Canadian Mutual Funds Association and of policies adopted by securities administrators. The C.M.F.A. rule, which is representative of those applicable with most mutual funds, re-

quires that a contractual plan purchaser be advised "that the amount of his initial investment will be promptly refunded to him in full upon receipt of his written request made within thirty days after the date of the signing of the application".* A similar rule applies to plans subject to termination fees.

14.100 Precise information on the extent of use of the two types of rescission rights was difficult to obtain because few, if any, distribution companies keep accurate records as to the frequency of their use. The difficulties were accentuated with the two-day right, which came into effect in Ontario only shortly prior to the distribution of our questionnaires and was only subsequently adopted in Alberta, Manitoba and Saskatchewan. Available information indicates that the thirty-day rescission right is exercised with between 3% and 4% of contractual plans sold. The extent of use of the two-day rescission right is much smaller, but this may well be attributable to the brevity of the period during which the right is available.

14.101 We have concluded that rescission rights play an important role in a scheme of investor protection. There are, however, a number of changes we believe to be necessary in the rescission rights presently available to purchasers if they are to be fully effective in the context of mutual funds. One change is in the determination of the period during which the right of rescission is available to the purchaser. We regard neither the time of delivery of the prospectus, presently the determining factor for the two-day rescission right, nor the time of signing the application, presently the determining factor for the thirty-day rescission right, as the ideal determinant. We comment in preceding sections of this chapter on the scant value of the prospectus for many investors; we are doubtful that even the introduction of the summary prospectus will improve the situation to the point where delivery of the prospectus will result in adequate and detailed consideration by all purchasers. In our opinion, the time when the investor is most likely to reconsider his decision, and the time from which the rescission period for sales of mutual fund shares or units should run, is the receipt of the confirmation including the information proposed in paragraph 14.92.

* Canadian Mutual Funds Association, Code of Ethics, section 3(a).

14.102 The confirmation is an important document because, particularly if it contains the information proposed in paragraph 14.92 and the following paragraphs, it will bring home forcefully the size of the sales charge and other relevant details concerning the investment. On receipt of this document, the purchaser is very likely to review the merits of his decision, particularly if he is motivated so to do by a statement on the confirmation reminding him of the availability of rescission rights. Another reason why it is desirable that the period of rescission rights should run from the time of receipt of the confirmation is that this will motivate the distribution company to process the sales order as expeditiously as possible, thereby further serving the best interests of the purchaser.

14.103 Another aspect of the existing regulatory structure governing rescission rights which we question is the adequacy of the time periods involved. Thirty days is in our opinion an appropriate period for contractual plans, particularly since we conclude below that the rescission right under a contractual plan should be confined to the first payment made under that plan. However, we have also concluded that two days is an inadequate period in other cases. We recognize that this short period was decided upon because a longer period would not be feasible with other types of security, in view of the possibility of price fluctuation during the period. We make proposals below which would resolve that problem in the context of mutual funds, and we have concluded that it would be feasible and desirable to allow a rescission period of seven days running from the delivery of the confirmation, for all purchases except those under contractual plans.

14.104 To allow a rescission right for every payment under a contractual plan would produce small additional benefit and would cause considerable inconvenience for the organizations concerned. This accounts for our conclusion that the right under such plans should be applicable only to the initial payment, and for this purpose we have concluded that a periodic payment plan subject to a redemption fee should be treated as a contractual plan; such periodic payment plans are discussed in paragraphs 2.27 and 10.123. The only exception

we propose to the restriction of the rescission right to the initial payment under contractual plans is that if any additional payment is made before the end of the thirty-day period after receipt of the confirmation, the rescission right should also apply to that additional payment.

14.105 In the context of lump sum transactions, we have considered whether rescission rights should be available to all purchasers. They are primarily for the protection of purchasers for whom mutual funds are unsought goods, but we have concluded that the distinctions between the two types of purchasers and the transactions in which they invest are not sufficiently precise to permit the restriction of rescission rights to such purchasers. Even if this could be done, we doubt that it should be done. In the absence of special considerations, it does not seem desirable to deny the benefit of an opportunity to reconsider the transaction to purchasers for whom mutual funds are shopping goods. The only type of purchase where special considerations are present is large transactions, in which possibilities of abuse are available through the volume discount. We have concluded that the benefit of rescission rights should therefore be denied in such transactions, particularly since most large volume purchasers treat mutual funds as shopping goods. The benefit of rescission rights should, therefore, not be available to purchasers who invest over $50,000 at one time.

14.106 Procedural problems arise in the application of rescission rights to the purchase of shares or units of mutual funds. These are attributable to the fact that the purchase price is allocated between sales charges and the net asset value of the shares or units purchased, with the latter amount invested directly in the mutual fund. Similar problems do not arise with other types of securities, for the underwriter has ordinarily acquired them from the issuing company for resale and the responsibility for payment is his. In the context of mutual funds, it is generally accepted that the distribution company must repay sales charges if the rights are exercised, but practices are not uniform as to whether the distribution company or the mutual fund bears the risk of fluctuation in value of the shares or units involved between the

time of purchase and the time of rescission. Such fluctuation could result in either a profit or a loss, depending on whether the value of the shares or units increased or decreased prior to the exercise of the rescission right.

14.107 The brief of the Canadian Mutual Funds Association notes the problem outlined in the preceding paragraph and recommends that

> when shares are redeemed as a result of a fund shareholder exercising a rescission option granted by the management company and/or fund distributor, that the management company and/or distributor reimburse the fund for any deficiency between the redemption price of the shares and their net asset value at the time of redemption. Conversely, any excess of net asset value at the time of redemption over the amount paid to the redeeming shareholder should be paid to the management company or distributor.

We have considered the arrangement proposed in this quotation, and have concluded that it is unnecessarily cumbersome. Purchasers should be required to take the risk of a decrease in the net asset value of their shares or units between time of purchase and time of rescission; they should equally be entitled to receive the benefit of an increase in net asset value. To require return of the full amount of their purchase price not only subjects the distribution company or the mutual fund to a possibility of windfall profits or unanticipated losses, it also encourages purchasers to exercise their rescission rights simply because of a decrease in net asset value. The refund of sales charges (including service fees and similar deductions) plus net asset value of shares or units is a sufficient benefit to be gained by the purchaser who rescinds. Upon the exercise of a right of rescission, the net asset value of the shares or units purchased should be paid by the mutual fund, subject to no redemption fee; and the sales charges, service charges and other deductions related to the mutual fund investment should be refunded by the distribution company.

14.108 Another difficulty arises from the fact that the amount paid by the purchaser often includes a sum attributable to items other than the net asset value of the shares or units purchased plus sales charges; the most frequent example is an initial insurance payment. We have concluded that rescission rights should not be required to extend to such separate payments, in cases where they are clearly separable from the mutual fund investment.

We do, however, encourage the development by distribution companies of arrangements whereby the rescission rights can also be applicable to such payments.

14.109 The procedure outlined in this section hinges on the confirmation of purchase. This document, acknowledging receipt of the initial payment under a contractual plan or of the payment for a lump sum purchase, should contain on the same side of the same piece of paper which sets out the information contemplated by paragraphs 14.92 to 14.94, a clear and concise statement of the rescission right and the manner and time in which it may be exercised. In order to enable the distribution company to determine whether the rescission period has expired, there should be a conclusive presumption that a mailed confirmation arrives at its destination in the ordinary course of mail. While it may seem unfair, we have concluded that no similar presumption should operate in favour of the purchaser when he gives notice of rescission; the right is such an extraordinary remedy, and leaves the distribution company in such a vulnerable position, that we have concluded the purchaser should have responsibility to ensure his notice of exercise of the right reaches the proper destination. Since that responsibility is his, the purchaser should not be restricted to the mails to give his notice of rescission; he should, for example, be permitted to give it by telegram.

14.110 For the reasons set out in this section, we recommend:

(1) that, subject to recommendation (2), a purchaser of mutual fund shares or units should be entitled to rescind his purchase by notice given within seven days after receipt of the confirmation for a lump sum purchase, and within thirty days after receipt of the confirmation for the initial payment under a contractual plan, which should for this purpose include a periodic payment plan subject to a redemption fee; for contractual plans, the rescission right should apply only to the initial payment and to any further payments made within thirty days after receipt of the confirmation for the initial payment;

(2) that the rescission rights proposed in recommendation (1) should not be available for purchases of over $50,000;

(3) that the amount refunded to the purchaser upon due exercise of his right to rescind should be the then net asset value of the shares or units purchased (subject to no redemption fee), which should be paid by the mutual fund; and the distribution company should refund the full amount of sales charges and other fees relevant to the mutual fund investment, but not including fees attributable to clearly separable items such as insurance; distribution companies should be encouraged to make arrangements whereby rescission rights will be applicable to the latter items;

(4) that the confirmations for the initial purchase under a contractual plan and for a lump sum purchase should contain, on the same side of the same sheet of paper on which the information contemplated by paragraph 14.96 is set out, a clear and concise statement of the right of rescission granted pursuant to recommendation (1), and the time and manner in which it may be exercised; and

(5) that the confirmation referred to in recommendation (4) should, when mailed, be conclusively presumed to be delivered in the ordinary course of mail, but that no similar presumption should apply to the notice whereby the right of rescission is exercised; the latter notice could be delivered by mail, telegram, or otherwise.

Annual and Interim Reports: Their Relationship with the Prospectus

14.111 In the operations of most public companies, annual and interim reports made to shareholders are of greater practical importance for the provision of continuing disclosure than are prospectuses, even though prospectuses ordinarily contain more comprehensive information. The fact that a prospectus need not be prepared except in connection with a public distribution of securities means that few companies file a prospectus more frequently than once every several years, while annual and interim reports are regularly available. The discrepancy between the extent of the information required to be included in a prospectus and that required to be included in an annual report is attributable

to the belief that the informational requirements of a new purchaser are greater than those of a person who is already a shareholder.

14.112 Each of the principal differences between annual reports and prospectuses is, in theory, irrelevant to most mutual funds. A mutual fund the shares or units of which are continuously being distributed to the public, which is true of most mutual funds, must maintain a prospectus in effect at all times. This means that the prospectus, through its more detailed contents, usurps the role of the annual report as the important continuing disclosure document. Secondly, it can be strongly argued that there is no difference between the informational requirements of potential purchasers and of present holders of mutual fund shares or units. The present trend in the regulation of public companies is towards a recognition that existing and potential shareholders have similar informational needs, because the existing shareholder can sell his shares or purchase additional shares at any time; the only major exception to this is companies which have not previously "gone public". There is even less reason to distinguish existing mutual fund shareholders or unitholders from potential purchasers than is true with most public companies, for the availability of the right to redeem facilitates the liquidation of a position in shares or units at any time.

14.113 The considerations set out in the preceding paragraph would, taken to their logical conclusion, lead to the abolition of the distinction between annual reports and prospectuses for a mutual fund the shares or units of which are continuously being sold to the public. We have considered whether we should make a recommendation to this effect, but have concluded against it. While it can be argued in theory that the informational needs of the potential purchaser and the present holder are the same, we recognize an important practical difference. The prospectus (or, under our proposals, the summary prospectus) is received at a time when the recipient is giving active consideration to the purchase decision. The annual report, on the other hand, is received by a person who is already the holder of shares or units and is unlikely at the time of receipt to be giving active consideration to a change in his investment.

14.114 Other considerations also motivate our conclusion that the existing distinction between annual reports and prospectuses of mutual funds should be maintained. The full prospectus is a bulky document, comparatively expensive to prepare and detailed in content; one of the reasons we propose a summary prospectus is our belief that it is unlikely that the full prospectus can be made simple to understand. We think it must continue to be bulky, and this fact would severely limit the advantage to be gained through the imposition of a requirement that the full prospectus be sent every year to every holder of shares or units. The annual report with its comparative brevity of content can be relied upon for the continuing reporting to existing shareholders or unit-holders. We have, however, concluded that a holder of shares or units should be entitled to receive a copy of the current full prospectus on request. This right, to which conspicuous reference should be made in the annual report, will satisfy the requirements of the holder who needs information which is more detailed than that set out in the annual report. In view of the availability of this right, we have concluded that the existing practice whereby a copy of each new prospectus is sent to each contractual planholder is unnecessary; of course, each contractual planholder should receive a copy of the annual report whether or not his shares or units are registered in his own name.

14.115 Our conclusion that the distinction between annual reports and prospectuses of mutual funds should not be abolished is not intended to imply that the two should be required to be separate documents. If a mutual fund organization wishes to prepare a single document as an annual report and a prospectus, this should not be prohibited. In a few cases the annual report of a mutual fund has been incorporated as one part of its prospectus, and this practice also should be permissible. We doubt that many organizations will take immediate advantage of either right, because of the problems which arise from the fact that prospectuses are, and annual reports are not, required to be approved by the appropriate administrator. It is to be hoped that the processing of prospectuses will eventually be done sufficiently expeditiously that it will become feasible to combine annual reports and prospectuses in a single document, or at least to incorporate the annual report in the prospectus.

14.116 Annual reports are frequently used by distribution companies as sales literature. We regard this as a desirable practice, because the annual report contains detailed financial information. In order to encourage this practice, and because the combination of the annual report and the prospectus might otherwise be impossible, we have concluded that the annual report should be permitted to contain material in addition to that which it is required to contain, provided that the additional material complies with the guidelines for sales literature formulated in accordance with paragraphs 14.73 to 14.75. Except in the cases discussed in the next paragraph, the only material which the annual report should be required to contain is that contemplated by the recommendations as to financial disclosure made in the following chapter.

14.117 The requirement that a prospectus be maintained in effect for the shares or units of a mutual fund ceases when the public distribution of its shares or units ceases. However, the informational requirements of its shareholders or unitholders do not end at that time. We have concluded that much of the information required to be included in a prospectus constitutes important disclosure which should continue to be available regardless of whether the distribution of shares or units continues. The mutual fund which does not have a currently effective prospectus for its shares or units should, therefore, include in its annual report all information required for the prospectus except information relating to the basis of sale of shares or units and except any additional information with respect to which an exemption is obtained from the appropriate administrator. Alternatively, the information not included in the annual report could be provided in a separate document available to shareholders or unitholders on demand. In the latter case, conspicuous reference to the availability of the additional document should be made in the annual report which is sent to shareholders or unitholders. This additional document might be a copy of the prospectus on file in another jurisdiction. A copy of every annual report, and of any such additional document, should be filed with the administrator so that it will be available for inspection by the public.

14.118 While the annual report is the most important report regularly distributed to holders of shares or units, it is rarely the only one. Most mutual funds regularly distribute semi-annual reports, and some also distribute quarterly reports. This frequency of reporting is dictated in part by applicable securities regulation, under which most mutual funds are required to report on a semi-annual basis, but it is also motivated by commercial factors. Distribution companies find that wide dissemination of reports contributes to sales, and the reports have the advantage that under prevailing practice most of the cost of their preparation is paid by the mutual fund. While for these reasons, semi-annual or quarterly reporting is comparatively frequent, a number of mutual funds report only on an annual basis. We have considered whether semi-annual or quarterly reporting should be required in all cases.

14.119 The tendency in the regulation of public companies in recent years has been towards requirements for more frequent reports to shareholders. In spite of the importance of such reports for most public companies, there are different considerations present with mutual funds. The most important difference lies in the nature of the information that can be provided in the report. With an industrial company, the analyst can often make valuable use of the information contained in the report for predictive purposes. With the mutual fund the information a report contains as to matters such as portfolio content may be completely out of date by the time the report is published; even if that were not the case, the comments in Chapter III on attempts to predict future performance on the basis of the historical record would cast doubt on the value of the information. The most important piece of information to the shareholder or unitholder, the net asset value per share or unit, is readily available to him on a current basis from newspapers or other sources.

14.120 The considerations set out in the preceding paragraph would seem to militate against a requirement for reports on a basis more frequent than annual, or indeed against any reports. In our opinion, however, a requirement for semi-annual reporting is justified, if only because investors are entitled to an account of stewardship more often than once in each year. We have

therefore concluded that semi-annual reports should be required for mutual funds, although more frequent reports should be permitted. We discuss the content of semi-annual reports in Chapter XV; with semi-annual as with annual reports, we have concluded that the inclusion of material in addition to that which is required should be permitted if it complies with the guidelines for sales literature formulated in accordance with paragraphs 14.73 to 14.75. Copies of all interim reports as of all annual reports should be filed with the administrator.

14.121 It is apparent from the factors described in the preceding paragraph that speed of publication is essential if annual and semi-annual reports are to be of any real value to holders of shares or units. Because we conclude in paragraph 6.81 that an auditor's report should not be required in an interim report, the time required for the preparation of the semi-annual report should be less than for the annual report. The information which we propose for inclusion in each report can be much more quickly compiled than can the corresponding information in the reports of an industrial company. We have concluded that the annual report should be distributed to holders of shares or units within 60 days, and the semi-annual report within 45 days, after the end of the period reported on. In both cases, the recipients should include all holders of shares or units including those who are not registered as such but whose investment is held in custody under arrangements of the type described in paragraphs 8.41 to 8.50.

14.122 For the reasons set out in this section, we recommend:

(1) that a holder of shares or units in a mutual fund, including a contractual planholder whether or not his shares or units are registered in his own name, should be entitled to receive on request a copy of the current prospectus of the mutual fund, and conspicuous reference to this right should be made in each annual report sent to shareholders or unitholders;

(2) that, subject to recommendation (1), legislation applicable to pros-

pectus deliveries should not require that each new prospectus be sent to each shareholder or unitholder, or to each contractual planholder;

(3) that the preparation of an annual report and a prospectus as a single document should be permitted but not required, and that the incorporation of the annual report into the prospectus should also be permitted but not required;

(4) that, subject to recommendation (5), the annual report of a mutual fund should be required to contain only the material contemplated by the recommendations in Chapter XV, but should be permitted to contain any other material which complies with the guidelines for sales literature formulated in accordance with paragraph 14.79;

(5) that when a mutual fund has ceased to effect public distribution of its shares or units and no longer has a prospectus in effect, the information which would be required to be included in a prospectus, other than information relating to the terms of sale of shares or units or information with respect to which an exemption is obtained from the appropriate administrator, should be made available in one of the following ways:

(a) through its inclusion in the annual report; or

(b) through the preparation of a separate document which would include all of the information except what is contained in the annual report and which would be made available on the same basis as a prospectus under recommendation (1);

(6) that reports to the holders of mutual fund shares or units should be required on a semi-annual basis, and more frequent reports should be permitted;

(7) that recommendation (4) should apply, with necessary changes, to semi-annual reports;

(8) that annual reports should be distributed to holders of shares or units within 60 days, and semi-annual reports within 45 days, after the end

of the periods reported on; the recipients should include all holders of shares or units, including those not registered as such but whose shares or units are held in custody under arrangements of the types described in paragraph 8.51; and

(9) that copies of all annual and interim reports, and of any documents prepared in compliance with clause (b) of recommendation (5), should be filed with the administrator.

CHAPTER XV

FINANCIAL DISCLOSURE BY MUTUAL FUNDS

15.01 As a financial institution, money and investments are the stock-in-trade of a mutual fund, and all other aspects of its affairs are peripheral to its financial position. It is therefore crucial that financial statements of mutual funds should be prepared so as to provide relevant information in a form both clear and meaningful. This objective is not satisfactorily attained at present because existing regulations are in large part designed for industrial companies and do not adequately recognize a number of special factors attributable to the method of operation of mutual funds. Another difficulty is that the applicable regulations to some extent reflect the natural tendency in the formulation of regulations on financial disclosure, to require that a large amount of information be set out. It is usually thought preferable to err on the side of including too much rather than too little.

15.02 In the conclusions reached in this chapter, we have endeavoured to pay heed to the special factors present with mutual funds, and to resist the tendency to recommend the disclosure of information that goes beyond what is relevant and meaningful. We are well aware of the fact that information provided in a few succinct and clear statements on two or three pages is far more likely to be read than would be four or five pages containing a proliferation of information. Additional special factors that have influenced our conclusions are discussed in the following section.

15.03 In our review of financial disclosure requirements we have engaged in extensive discussions with interested persons. A number of briefs and submissions have been received, in the form of recommendations concerning financial disclosure or of discussions of a detailed report which was prepared by consultants to this Committee and circulated for comment. Our staff has met with representatives of the organizations that prepared briefs or submissions for more detailed reviews of their suggestions. We have had the benefit of this type of contact with interested persons and organizations on every aspect of our work, but it has been of particular value in the resolution of problems discussed in this chapter.

15.04 The financial disclosure requirements presently applicable to mutual funds in Canada differ considerably between jurisdictions. For convenience, we refer throughout this chapter to those of Ontario. We selected that province because of the number of mutual funds qualified for sale to its residents(86 at the end of 1968, as compared with 84 for Quebec, the province with the next largest number) and because The Securities Act, 1966 (Ontario) has become the model for corresponding legislation in several other provinces. An amendment made in 1968 to The Securities Act, 1966* with specific reference to mutual funds has not been generally adopted in other provinces at the time of writing, so that the position differs even among provinces which look to The Securities Act, 1966 (Ontario) as their model. Mutual funds qualified for sale to the public in Ontario, however, almost invariably follow the Ontario practice in prospectuses filed with other provincial securities administrators, so that the Ontario legislation may fairly be regarded as representative of general practice.

15.05 In the following sections we first consider certain special factors relating to financial disclosure by mutual funds, particularly the nature of the informational needs of persons to whom the disclosure is made. Such special factors also include the potential impact of the recommendations made in Chapter V concerning the equity structure of mutual funds. The remainder of the chapter is devoted to the form and content of financial statements.

* Statutes of Ontario, 1968, c.123.

Special Factors Relating to Financial Disclosure By Mutual Funds

15.06 In order to restrict financial disclosure requirements for mutual funds to information which is relevant and meaningful, it is necessary to allow for several factors, at least some of which are unique to the mutual fund industry. The most important factor is discussed in paragraphs 14.112 to 14.114, where we conclude that, in theory, the informational requirements of existing shareholders or unitholders do not differ from the needs of potential investors. We recognize a practical difference between them because the potential purchaser receives information at the time when he is giving active consideration to the purchase decision, which may not be true of the present holder. For that reason we conclude in paragraph 14.114 that the distinction between the prospectus and the annual report, with the former as the more complete disclosure document, should be retained. Financial information is, however, of such importance that the practical difference in the time of delivery should not be permitted to affect the nature of the information required. We have concluded that the financial information to be required in prospectuses of mutual funds should be identical with that required in their annual reports.

15.07 The restricted nature of liabilities which are or may be incurred by mutual funds is another factor that has influenced the conclusions set out in this chapter. The great majority of mutual funds incur liabilities only to their brokers or their management companies. Both brokers and management companies are perfectly capable of taking care of themselves; it is not necessary to consider their needs in the formulation of disclosure requirements. A few mutual funds are permitted to borrow money, and implementation of our conclusion in Chapter XII that non-conventional funds should be allowed to do so will result in an increase in the number of mutual funds with that right. However, under our recommendations in paragraphs 5.73 to 5.77 the borrowing will be restricted to institutional lenders which can protect themselves as effectively as can brokers and management companies. For these reasons, it is not necessary in the formulation of mutual fund financial disclosure requirements, to take into account the informational needs of creditors as distinct from those of shareholders or unitholders.

15.08 Another factor which has influenced the conclusions reached in this chapter is that a mutual fund carries on only one business enterprise: raising and investing money, with the investing almost invariably being done in readily marketable securities. We would not think it appropriate for an organization which satisfies the definition of a mutual fund proposed in Chapter V through the issuance of equity securities redeemable at net asset value on demand by the holder, to carry on any other type of business activity: implementation of our conclusions in Chapter XII would prevent it from doing so. For that reason, we have been able to shape our recommended scheme of disclosure for application to the specific enterprise of raising and investing money without allowance for the development of other enterprises by mutual funds.

15.09 In Chapter V, we conclude that the traditional legislative provisions concerning corporate share structure and the sources from which dividend payments and payments on redemption of shares or units may be made are inappropriate to mutual funds. No similar legislative requirements are imposed on trusts, and we conclude that the law applicable to incorporated mutual funds should be amended to accord with that applicable to mutual funds organized as trusts. The conclusions in this chapter are premised on the assumption that those in Chapter V as to the equity structure of mutual funds will be implemented. If the latter conclusions are not implemented, a considerable degree of simplicity and of uniformity in the presentation of financial information by mutual funds will be sacrificed.

15.10 The most important feature of the recommendations in Chapter V from the viewpoint of financial disclosure is that their implementation would reduce the shareholders' or unitholders' equity sections in the balance sheets of all mutual funds, incorporated or unincorporated, to a single entry. This entry, which would equal total net assets, would be far more readily comprehensible to investors than the assortment of entries that now appears in that section of the balance sheets of many mutual funds, particularly incorporated mutual funds. Because implementation of this recommendation would eliminate the

necessity for a distinction between incorporated and unincorporated mutual funds in the presentation of financial information, the conclusions in this chapter relate to both types of mutual fund except where the contrary is specifically stated.

15.11 Financial information for most public companies relates to the company as an entity; earnings, expenses and similar information are usually expressed for the company rather than on a per share basis. The nature of a mutual fund is such that information of this type is not only of less value, but might be very misleading. Total net assets of a mutual fund may change greatly during a year, and if that change occurs as a result of issuance or redemption of shares or units rather than of variations in value of portfolio holdings, aggregate information can be deceptive. In addition, the shareholder or unitholder regards the mutual fund as an investment vehicle; he is interested in its results on a per share or unit basis, not in total. For these reasons, the conclusions in this chapter give very considerable stress to the importance of information presented on a per share or unit basis.

15.12 In view of the importance we accord to financial disclosure by mutual funds, we have considered whether to recommend the promulgation of a code of regulations that would deal with all important aspects of the accounting practices of mutual funds. We have decided against this approach, although we make recommendations in this chapter and elsewhere in the report concerning certain specific aspects of accounting practices which have caused us concern. Accounting practices are in large part dictated by the form and content of the financial statements to be presented, a question dealt with in detail in this chapter. We have concluded that before any attempt is made to evolve a code of accounting practices, time should be taken to ascertain what changes in existing practices will result from implementation of the recommendations made in this chapter. Except to the extent implicit in the requirements outlined below concerning the form and content of financial statements, no code of accounting practices should be imposed on the mutual fund industry until after legislation to implement our recommendations has been in effect for a reasonable period. The legislation should include provisions conferring power for the promulgation

of regulations either dealing with specific problems of accounting practice or embodying a complete code; the power should extend to regulations that define the nature of the books and records to be kept with respect to mutual fund operations. It is possible that this power will never have to be used.

15.13 For the reasons set out in this section, we recommend:

(1) that the requirements applicable to financial disclosure in annual reports and in prospectuses of mutual funds should be identical;

(2) that, except where the contrary is specifically stated in recommendations made in this chapter, the requirements referred to in recommendation (1) should not differ between incorporated and unincorporated mutual funds; and

(3) that legislation which implements our recommendations should contain authority for the passage of regulations to resolve specific problems of accounting practice or to embody a complete code of accounting procedures; the power should include the passage of regulations concerning the nature of the books and records to be kept with respect to mutual fund operations.

Comparative Financial Statements for Mutual Funds

15.14 In paragraph 15.11 we comment that the nature of a mutual fund operation is such that financial statements for the mutual fund as an entity, rather than on a per share or unit basis, not only are less important to the investor than is the case with other public companies, but may be misleading. The importance of this point is accentuated when consideration is given to comparative statements for prior years of the mutual fund as an entity. Comparative statements for prior years are not only desirable but almost essential for most other public companies; for that reason applicable legislation often requires that prospectuses, and sometimes annual reports as well, include financial information for the year reported on and information on a comparative basis for a number of preceding years. We have concluded that no such requirement should be imposed on mutual funds.

15.15 Our conclusion that comparative financial statements for mutual funds may be misleading arises from difficulties in interpretation of financial statements that relate to the mutual fund as an entity. These difficulties are attributable to the method of operation of mutual funds, and to the effect that changes in total net assets through purchases or redemptions of shares or units may have on all the financial information. So pronounced is this effect that comparative statements of mutual funds may be comprehensible only to the most sophisticated investors. This point is well expressed in the brief submitted to us by The Canadian Institute of Chartered Accountants:

> It is generally accepted that income statements should be presented on a comparative basis for two or more years. Comparative income statements of most companies are usually useful for showing the trend of earnings. In a mutual fund, however, a growth in total income is often primarily the result of the issue of new shares or units rather than more profitable operations. A rapid growth pattern, in total income figures, might erroneously be attributed to a successful investment policy when in reality it arose only from increased participation by investors. As such comparative figures of a mutual fund for a period of years may be misleading to investors they should be presented only in conjunction with per share figures, to place the information in its proper perspective. However, as comparative income statements for a number of years may be misleading, even if presented in conjunction with per-share figures, it is preferable to present them for not more than two periods. Comparative earnings figures for more than two consecutive periods should be presented in terms of per-share figures only.*

15.16 While the arguments made in the above quotation are addressed specifically to comparative income statements, we find them equally persuasive concerning other financial statements of the mutual fund. Here, and elsewhere in its brief, the Institute recommends that disclosure be required for "not more than" two periods. We have concluded that, speaking generally, any benefits to be gained by a requirement that annual reports and prospectuses contain financial information for more than one period would be more than outweighed by the inconvenience resulting from the volume of material required, and by the possibility that unsophisticated persons might be misled. This conclusion relates only to financial statements for the mutual fund as an entity; in paragraphs 15.53 to 15.60 we propose a requirement for the disclosure of comparative information on a per share or unit basis.

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* The Canadian Institute of Chartered Accountants, <u>Brief To The Canadian Committee on Mutual Funds and Investment Contracts</u>. (Toronto: June 1968), pp. 5-6.

15.17 One situation should be mentioned in which existing procedures require the publication of financial statements for a prior period. When a mutual fund applies for prospectus filing more than ninety days after the end of a fiscal year, the applicable requirements in several provinces permit the inclusion in its prospectus of financial statements for its preceding fiscal year, reported on by an auditor, together with statements for the period since the beginning of the current year, not so reported on. This might seem to be inconsistent with the policy against comparative statements. In our opinion there is no inconsistency. The objective of the practice is not to provide comparative information but to reconcile the need for an auditor's report with the need for current information. In any event, we have concluded that the flexibility provided by the availability of this procedure should be preserved.

15.18 It is possible that in some cases the appropriate administrator might consider that comparative statements for prior periods were necessary to convey certain information to the recipients. We think that such cases would be rare, but they might occur. There could, for example, be some radical change in the method of operations of the mutual fund, the implications of which are not adequately reflected in other information included in an annual report or a prospectus. The administrator should have power to require comparative financial statements in these cases, although this alone should not be regarded as making it desirable that annual reports be reviewed in advance by administrators. This should be the only instance apart from the five-year per share or unit statistical summary proposed in paragraph 15.53 in which the annual reports or prospectuses of mutual funds would be required to include comparative financial information.

15.19 Some mutual fund organizations may wish to provide their shareholders or unitholders with comparative financial statements even though not required so to do by statute. This would be permitted under our conclusion in paragraph 14.116 provided that the comparative statements were in compliance with the guidelines for the content of sales literature. We have concluded that certain additional protective requirements are necessary to ensure that the right to include comparative statements is not abused. We have reviewed a

prospectus of one mutual fund in which financial statements for a prior period when performance was good appear in large type early in the document, and those for the current period appear later in the document and in smaller type. While this is a particularly flagrant instance, we have seen other documents in which comparative statements are used in a fashion that could mislead any but the most sophisticated and careful reader. The requirements we propose are designed to avoid this without preventing the proper use of comparative statements.

15.20 Any comparative financial statement published voluntarily should comply with the following rules:

(a) it should be accompanied by an auditor's report to the effect that it has been prepared on accounting principles consistent with those on the basis of which information for the current period was prepared; or, alternatively, that specified changes in accounting principles were made. In the latter case the nature of the changes should be explained and details should be provided as to the extent of their effect on the relevant information;

(b) it should also be accompanied by a complete explanation, by note or otherwise, (which would not be required to be reported on by the auditor) indicating qualifying factors that might otherwise mislead the reader who attempted to draw conclusions from comparisons between the statements; and

(c) it should be given less prominence than the statements for the current period; this would be done through its reproduction in smaller type or less leaded type, and its appearance to the right of the current statement when in parallel columns, and after it when on consecutive pages.

One exception should be made to these requirements. Items (b) and (c) should not be applicable to a one-year comparative statement of changes in net assets. These statements, discussed in paragraphs 15.48 to 15.52 highlight the issuance and redemption of shares or units and it is less likely that changes attributable to these factors will mislead the reader. In addition, there are types of

analysis the prospective investor might wish to make which would be assisted by the availability of comparative statements of changes in net assets.

15.21 For the reasons set out in this section, we recommend:

(1) that the annual reports and prospectuses of mutual funds should not be required to include comparative financial statements for the mutual fund as an entity;

(2) that for purposes of these recommendations the inclusion in a prospectus of financial statements reported on by an auditor and accompanied by financial statements for a subsequent period of less than a year not reported on by an auditor should not be considered to constitute the publication of comparative statements;

(3) that, notwithstanding recommendation (1), the appropriate administrator should have power to require the inclusion of comparative financial statements in an annual report or a prospectus if he concludes that important information would otherwise be inadequately revealed; this recommendation should not be regarded as making it desirable that annual reports be reviewed in advance by administrators;

(4) that the inclusion on a voluntary basis of comparative statements in an annual report or a prospectus should be permitted provided that they comply with the guidelines for sales literature formulated in accordance with paragraph 14.79 and further provided that any such comparative statement:

(a) is accompanied by an auditor's report to the effect that it has been prepared on accounting principles consistent with those on the basis of which information for the current period was prepared; or, alternatively, that specified changes in accounting principles were made. In the latter case the nature of the changes should be explained and details should be provided as to the extent of their effect on the relevant information;

(b) is accompanied by a complete explanation, by note or otherwise, (which would not be required to be reported on by the auditor)

indicating qualifying factors that might otherwise mislead the reader who attempted to draw conclusions from comparison between the statements; and

(c) is given less prominence than the statements for the current period; this would be done through its reproduction in smaller type or less leaded type, and its appearance to the right of the current statement when in parallel columns, and after it when on consecutive pages;

Clauses (b) and (c) should not be applicable to a one-year comparative statement of changes in net assets.

Financial Statements of Mutual Funds: General

15.22 In the following sections we review and explain our conclusions concerning the content of the financial statements to be included in the prospectuses and annual reports of mutual funds. Many of our proposals are very similar to the corresponding requirements of The Securities Act, 1966 in Ontario and the regulations thereunder. We make frequent references to those provisions, particularly where our conclusions differ materially from them.

15.23 In this discussion we rely heavily on exhibits which illustrate the form of the various financial statements. It would seem appropriate that legislation or regulations which implement our recommendations should embody these exhibits as models. However, we do not propose that mutual fund financial statements should be required to conform to them. Such a conclusion would be to some extent inconsistent with the conclusion set out in paragraph 15.12, that we do not propose the legislative adoption of a uniform code of accounting practice. Instead, mutual fund financial statements should be required to provide at least the information contemplated by our exhibits. Those items of information that we consider to be adequately dealt with by the exhibits and the notes thereto are not separately discussed in the text.

15.24 The exhibits include a number of notes, and additional proposals as to information which should be supplied by way of note are contained in the text. In many cases it would be convenient to supply some or all of this information by way of note appended to the financial statements as a whole rather than to a specific statement. Even where the notes are appended to a specific statement, it might be preferable to combine notes that we suggest be appended to separate statements. The applicable requirements should be sufficiently flexible to permit adjustments such as these, if they are conducive to clarity of presentation.

15.25 For the reasons set out in this section, we recommend:

(1) that legislation or regulations which implement the recommendations made in this chapter should include exhibits, substantially in the forms set out in the following sections, to serve as models of the several financial statements; conformity to such models should not be required, although the financial statements published should provide at least the information contemplated by the models; and

(2) that in cases where we recommend that information should be furnished by way of note, it should be permissible to provide the information by way of note to the financial statements or by way of note or notes to specific financial statements, or in a combination of these ways, provided that the method adopted is conducive to clarity of presentation.

The Statement of Income and Expenses

15.26 Exhibit 15-A is a model form of income statement which indicates the information that should replace the statement of profit and loss currently required of mutual funds, as of other companies, under The Securities Act, 1966 (Ontario). We have concluded that an income statement containing the information contemplated by Exhibit 15-A will provide a very clear indication of the income and expenses incurred by the mutual fund during the period reported on. In particular, it will provide a detailed breakdown of management expenses, a matter the importance of which is stressed in our discussion of management fees in Chapter X. One major expense item is omitted from this exhibit because

EXHIBIT 15-A

(NAME OF MUTUAL FUND)

STATEMENT OF INCOME AND EXPENSES

FOR THE YEAR ENDING 19__

Investment Income

Dividends..	$	
Interest...	$	
Other Income (specify or explain by way of note)........	$	

Expenses

Management Fee (Note 1)............................	$	
Audit Fees...	$	
Directors' Fees....................................	$	
Custodian's Fees...................................	$	
Legal Fees...	$	
Salaries (Note 2)..................................	$	
Shareholders' Information Costs....................	$	
Other Expenses.....................................	$	
	$____	$ ____
Income Before Taxes................................		$
Provision for Income Tax (Note 3)..................		$ ____
Net Income for the Year............................		$ ____

Notes:

1. The management fee should include the total fees paid to the investment manager for portfolio management, investment advice and other services. The basis for calculatiing the management fee should be stated. The services received should be outlined either in the note or in textual material in the same document (shareholders' report or prospectus).

2. Indicate the nature of services rendered to the mutual fund by persons to whom it pays salaries. If the mutual fund has a management company, the note should explain why such salaries are regarded as allocable to the mutual fund.

3. State the basis of the tax calculation and explain the tax position of the mutual fund. This information should be provided by way of note or in accompanying textual material whether or not any income taxes are paid or payable by the mutual fund.

4. Any of the specified expenses apart from management fees, audit fees, directors' fees, custodian's fees and legal fees which accounts for less than 5% of the total expenses during the year for which information is given may be omitted and the relevant amount included in "Other expenses", with an appropriate explanation made by note. If any other category of expenses accounts for over 5% of total expenses, an item with respect thereto should be added. If other categories of income than dividends and interest account for less than 5% of total income, they should be aggregated under "Other income" and an appropriate explanation made by note. Any such categories which account for in excess of 5% of total income should be separately stated.

its inclusion would be impracticable. Brokerage and other charges paid to securities dealers in connection with the implementation of transactions are a major item of expense for most mutual funds, but could not properly be reflected as expenses in a statement of income and expenses since such a statement does not also reflect profits and losses made on capital account. In paragraph 15.44 we propose that certain information relative to such expenses should be disclosed by way of note to the information on the mutual fund's portfolio.

15.27 Separate briefs submitted to us by the Canadian Institute of Chartered Accountants and by the Canadian Mutual Funds Association both suggested that a statement of income and expenses should be required of mutual funds. Exhibit 15-A includes more detail than contemplated by the forms of statement proposed by the Institute and the Association. The disclosure of expenses contemplated by Exhibit 15-A would be in greater detail than suggested by the Institute, and some of the explanatory notes in the exhibit would require information not suggested by the Institute. The most significant difference between the content of Exhibit 15-A and the form of statement suggested by the Canadian Mutual Funds Association is that Exhibit 15-A would require the disclosure, where income taxes are applicable, of income before taxes, provision for income taxes, and income after taxes. Whether or not income taxes are applicable, Exhibit 15-A would require an explanation by way of note or of accompanying textual material concerning the income tax position of the mutual fund; such an explanation should, in appropriate cases, explain the extent to which income of the mutual fund is treated as income of the shareholder or unitholder. The form suggested by the Association would include a note or reference concerning taxes only in years when the tax basis changes; we reject this approach because such information should, in our view, be available to the reader of the annual report or prospectus without the necessity to study similar documents released in prior years.

15.28 Our proposed statement of income and expenses also differs from the requirements of The Securities Act, 1966, (Ontario), with respect to statements of profit and loss. Most of the differences are attributable to the fact that we have designed Exhibit 15-A specifically for mutual funds.

In addition, Note 2 to the exhibit proposes that the nature of the services rendered to the mutual fund by persons to whom it pays salaries should be disclosed instead of the information presently required concerning salary payments under Form 12 of The Securities Act, 1966. Item 17 of that form requires a statement of remuneration paid to directors and senior officers. Our researches indicate that such payments rarely reflect total remuneration of directors and senior officers, because they receive additional payments from the management company. We think a more relevant question is what services are provided by those to whom the mutual fund makes payments which justify having the payment made by the mutual fund rather than by the management company.

15.29 Our conclusion that comparative statements of income and expenses for prior years should not be required, and that their inclusion on a voluntary basis should be subject to compliance with the conditions specified in paragraph 15.20 might be criticized with respect to one situation. It leaves open the possibility that a significant variation in expenses from year to year might be overlooked although it would be highlighted through the use of comparative statements. We think that this possibility should be allowed for, but we do not think that comparative income statements would be an appropriate technique for this purpose. Many expense items fluctuate with the total size of the mutual fund, and differences in expenses between consecutive periods which appear remarkable on initial inspection may be solely attributable to that factor. Instead, we have concluded that the relevant legislation should include a requirement for the annual report or prospectus to describe and explain by note or accompanying textual material any unusual changes in expenses from year to year that are not adequately accounted for by changes in total assets of the mutual fund.

15.30 For the reasons set out in this section, we recommend:

(1) That the financial statements of a mutual fund in its annual report and prospectus should include a statement of income and expenses containing the information contemplated by Exhibit 15-A and the notes thereto; and

(2) that any unusual changes in expenses from year to year that are not adequately accounted for by changes in total assets of the mutual fund should be described and explained by way of note to the statement of income and expenses or accompanying textual material.

The Statement of Net Assets and Shareholders' or Unitholders' Equity (Balance Sheet) with Supplementary Information on Portfolio

15.31 Exhibit 15-B is a model form of a statement of net assets and shareholders' or unitholders' equity, often referred to as a balance sheet. The recommendations made in Chapter V and referred to in paragraph 15.09 have enabled us to prepare this statement as a very simple document by comparison with those it would replace, particularly in the context of incorporated mutual funds. Our conclusion that Exhibit 15-B should be adopted assumes the implementation of the recommendations made in Chapter V; this assumption is made throughout this chapter but is of particular importance in the present context. Another factor which has contributed to the simplicity of presentation contemplated by Exhibit 15-B is that allowance need not be made for the possibility that the mutual fund might carry on other activities than the investment of its assets.

15.32 Exhibit 15-B is consistent with the recommendations made by the Canadian Institute of Chartered Accountants and does not differ materially from the corresponding form suggested by the Canadian Mutual Funds Association. We agree with the approach adopted by each of these organizations that the statement of net assets and shareholders' or unitholders' equity should include only a single item for investments at market value, with their cost separately indicated. Information concerning the investment portfolio should also be separately provided. We consider the nature of such information later in this section.

15.33 The entries in Exhibit 15-B include provision whereby subscriptions for shares or units sold but not paid for may be reflected as assets and the amount owing on shares or units redeemed for which payment has not been made may be reflected as liabilities. Inclusion of these items should not be regarded as an indication that we approve of the practices which they reflect.

EXHIBIT 15-B

(NAME OF MUTUAL FUND)

STATEMENT OF NET ASSETS AND SHAREHOLDERS' (UNITHOLDERS') EQUITY

AS AT ________ , 19__

Assets

Cash and term deposits..............................	$ ______	
Dividends and accrued interest receivable...........	$ ______	
Accounts Receivable:		
Shares (Units) sold.............................	$ ______	
Portfolio securities sold.......................	$ ______	
Other Assets (Note 3)...........................	$ ______	$ _____

Investments at Market Value

(Cost:$) (Note 1)...........................	$______	
Total Assets...................................		$ _____

Liabilities

Accounts Payable:		
Accrued Expenses................................	$ ______	
Portfolio Securities Purchased..................	$ ______	
Shares (Units) Redeemed.........................	$ ______	
Income Taxes Payable............................	$ ______	
Other Liabilities (specify or explain by note)..	$ ______	$_____
(Total Net Assets-Shareholders' (Unitholders') Equity)........................		$_____

Net asset value per share (unit)
(No. outstanding ____) (Note 2) $ ______

Notes:

1. If the basis of computation of cost is other than average cost, an explanation should be provided.

2. If the mutual fund has outstanding more than one class of shares or units, ranking equally against the portfolio but differing in other respects, they should be aggregated in the determination of net asset value per share or unit but an explanatory note as to the difference between classes and the number of each class outstanding should be appended. Such a note should be included even where shares or units of one class are authorized but not issued, unless a binding undertaking is given to the appropriate administrator that the mutual fund will not issue any of those shares or units.

3. Any of the specified classes of assets which accounts for less than 5% of the total assets at the date reported on may be omitted and the relevant amount included in "Other assets", with an appropriate explanation made by note. If any other category of assets accounts for over 5% of total assets, an item with respect thereto should be added. Similar procedures should be followed with respect to any of the specified classes of liabilities which accounts for less than 5% of total liabilities, and any other class of liabilities which accounts for over 5% of total liabilities.

The extension of credit on purchases, and delaying payments on redemptions, are both undesirable practices which should be discouraged; in paragraphs 13.102 to 13.111 we conclude that there should be statutory restrictions on the latter practice. When computing total net assets for the determination of management fees based on total net assets, subscriptions receivable for shares or units sold but not paid for should not be regarded as an asset.

15.34 The most important part of the financial information concerning a mutual fund is that which relates to its investment portfolio. Theoretically this information should form part of the statement of net assets, but that would be unworkable and we agree with the prevailing practice under which the information is included in a separate portfolio statement. We have concluded that such a statement should be required; the real problem is what information it should contain. This is one of the most difficult questions that we have had to resolve concerning financial disclosure. On the one hand, it is important for interested persons to be provided with full disclosure of relevant information concerning portfolio assets and trading policy - information which is crucial to a proper assessment of the quality of management on any reasonable basis other than yield. On the other hand, full implementation of this objective through a requirement that all prospectuses and annual reports must contain a quantity of information sufficient to satisfy the financial analyst interested in a detailed trading study could result in the provision, at considerable cost, of a mass of data sufficient to overwhelm most recipients. This is one area where limits must be accepted on the extent to which the objective of full disclosure may feasibly be implemented.

15.36 Item 28(1)12 of the regulations promulgated under the Securities Act, 1966 (Ontario) requires disclosure of the following information concerning mutual fund investment portfolios: (a) the name of each issuer of the securities held; (b) the class or designation of each security held; (c) the number of each class of shares or aggregate face value of each class of other securities held, and (d) the cost and market value of each class of securities held and if the carrying value is other than average cost, the basis of valuation. We have received a number of submissions concerning the adequacy

of this requirement. So far as we are aware, the desirability of inclusion in annual reports and prospectuses of items (a), (b) and (c) and of the information in item (d) other than cost of securities held is unquestioned, and we have concluded that this information should continue to be required. More difficulties arise with the desirability of the cost information in item (d), and with whether any information in addition to these items should be required.

15.37 A submission made to us by the Canadian Mutual Funds Association contains the following comment with reference to disclosure of the cost of securities held in the portfolio:

> Disclosure of cost of holdings is largely irrelevant since it tends merely to reflect date of acquisition. Future performance of identical portfolios will be identical, regardless of the acquisition date. These data are apt to lead to misleading calculations of the percentage of the portfolio on which the fund has taken a profit, ignoring positions which have been opened and closed since the last statement, and ignoring the fact that successful diversification requires that "A" and "B" be bought in the face of uncertainty as to the state of nature "C" or "D", with the full recognition that if "C" materializes a loss will be taken on "A" and a gain realized on "B", with the reverse true if "D" materializes.

We agree with the comments made in the above quotation, and we also think that an awareness of being judged by comparison between cost and market value of portfolio securities may act as an unrealistic constraint on portfolio managers in the determination of investment decisions. The submission of the Canadian Mutual Funds Association goes on, however, to recommend disclosure of cost on the theory that it may be of value for financial analysts.

15.38 We have discussed disclosure of cost of security holdings with the Government Relations and Legal Affairs Committee of the Montreal Society of Financial Analysts, and have been advised that only by a slight majority do its members believe that disclosure of information as to cost is necessary. Our other consultants are in agreement with the principles expressed in the quotation in the preceding paragraph, and in following paragraphs we propose requirements for disclosure of certain information designed specifically for

financial analysts. We have concluded, on balance, that information as to the cost of portfolio holdings should not be required to be included in the financial statements of the mutual fund. The statement of net assets and shareholders' or unitholders' equity should, as contemplated by Exhibit 15-B, include total portfolio cost. In our opinion, the recipient of financial information who wishes to conduct an historical analysis of performance will derive more benefit from the per share or unit statistical summary proposed in paragraphs 15.53 to 15.59 than he would from a comparison between cost and market value of portfolio securities.

15.39 The information concerning portfolio holdings outlined above will be sufficient for the purposes of most investors. As indicated above, the Government Relations and Legal Affairs Committee of the Montreal Society of Financial Analysts has suggested that additional information should be disclosed for the primary benefit of the financial analyst, and we agree that certain additional information would be desirable. Only through the availability of such information will more sophisticated techniques for comparative assessments of the quality of the services rendered by mutual fund management companies be developed. We have therefore concluded that the financial statements of a mutual fund should be required to include, as part of the portfolio statement or by a separate statement, summary information concerning portfolio transactions.

15.40 The information to be supplied concerning portfolio transactions would relate to each class of securities traded in by the mutual fund during the period reported on, whether or not securities of that class were included in its portfolio at the date as of which the report was made. The name of the issuing company of each such class of securities should be given together with particulars of the class in question sufficient to identify it accurately. The summary information relative to transactions in securities of that class would consist of the aggregate number (or face value, with debt instruments) and cost of securities purchased, and the aggregate number or face value and proceeds of securities sold. Equity and debt instruments should be separated and sub-totals provided to facilitate analysis of portfolio turnover.

15.41 In many instances mutual funds engage in a considerable number of transactions in comparatively short-term debt instruments, either as a defensive posture when a market decline is anticipated or simply as a method for the productive use of money pending the availability of a favourable investment opportunity. To require disclosure of such transactions, even in the summary form proposed in the preceding paragraph, would result in a very considerable increase in the space required with minimal additional benefit to the analyst. We have therefore concluded that the relevant legislation should permit transactions in debt instruments maturing within a year after purchase by the mutual fund to be aggregated for disclosure purposes although such instruments are of different classes and issued by different companies or governments. One exception should be made; where any of the debt instruments are issued by companies associated with the mutual fund within the meaning of that term as defined in paragraph 9.26, separate disclosure in the form contemplated by the preceding paragraph should be required.

15.42 Representatives of the mutual fund industry have expressed concern to us that disclosure requirements concerning portfolio holdings or portfolio transactions might cause harm to the organizations concerned. This would occur if the requirements forced the publication of information which would reveal that the mutual fund was engaged in an accumulation or liquidation programme with respect to a particular security; such publication might prejudice the successful completion of the programme. We doubt that these situations would be of frequent occurrence, for financial statements are rarely published until at least thirty days after the end of the period reported on and it would be rare for secrecy concerning such a programme to be maintained over that period. However, it is worthy of consideration, even if the situation would arise only on rare occasions, for we would hesitate to recommend the imposition of a disclosure requirement that might prejudice the mutual fund involved. We have concluded that provision should be made to avoid this possibility.

15.43 The relevant legislation should permit the inclusion in a portfolio statement of a heading "miscellaneous securities" under which securities representing not more than 5% by value of the total net assets of the

mutual fund could be included. This right would be subject to the requirement that in the next set of financial statements of the mutual fund published in a corresponding report (i.e. the next prospectus where the privilege is used in a prospectus, or the next annual report where the privilege is used in an annual report) there be provided the previously omitted information as to the securities included under the category "miscellaneous" in the preceding report, and the reasons for the omission of information concerning them. Where securities of certain classes are omitted from the portfolio statement, the omission of transactions in such securities from the transaction statement should also be permitted, subject to a corresponding requirement for publication of the missing information in the next report.

15.44 Closely related to information concerning portfolio holdings and transactions is information on brokerage and portfolio turnover. Brokerage is often, or usually, a major cost for the mutual fund, although as noted in paragraph 15.26 it would be inappropriate for inclusion in the statement of expenses. We have concluded that information concerning brokerage costs may be of considerable importance, and that it should be disclosed by way of note. Ideally, such a note should indicate the total compensation paid by the mutual fund to brokers or others with respect to portfolio transactions. Unfortunately, this would be very difficult or impossible to determine in most cases; compensation may be earned by way of a mark-up where the broker or other intermediary sells to the mutual fund as principal, and the amount of such compensation may be unknown to the mutual fund. In view of these difficulties, we have concluded that an estimate of broker compensation should be accepted when precise information cannot be obtained.

15.45 The information to be reflected in the note on brokerage costs should include the amount of commission payments to brokers or others during the period reported on. Such information would be subdivided into commissions with respect to common and preferred stock, and commissions with respect to debt instruments. A separate category would be permissible for short-term debt instruments of the kind described in paragraph 15.41. Separate information should be provided as to other types of compensation than commission payments;

if such information is an estimate, the method of calculation should be explained. The information provided pursuant to these conclusions should reflect all transactions, whether or not information as to the transactions themselves is included in the recommended transaction statement.

15.46 We have considered and decided against a recommendation that mutual funds should be required to compute their portfolio turnover according to a prescribed formula and to publish the resultant figure. We do not consider it feasible to arrive at a formula with sufficient precision for statutory enactment and yet with sufficient flexibility to allow for the various situations which can arise. On the other hand, the financial press should be able to compute portfolio turnover on a uniform basis through use of the information included within our recommended disclosure requirements. Dissemination of the portfolio turnover ratios so computed would facilitate comparisons on this question by the interested analyst or prospective investor.

15.47 For the reasons set out in this section, we recommend:

(1) that the financial statements of a mutual fund in its annual report and prospectus should include a statement of net assets and shareholders' equity containing the information contemplated by Exhibit 15-B and the notes thereto;

(2) that in the computation of total net assets for the determination of management fees based on that figure, subscriptions receivable for shares or units sold but not paid for should not be regarded as an asset;

(3) that, subject to recommendation (6), the financial statements of a mutual fund in its annual report and prospectus should include a statement containing the following information as to its investment portfolio at the date of the statements:
   (a) the name of each issuer of the securities held;
   (b) the class or designation of each security held;
   (c) the number of each class of shares or aggregate face value of each class of other securities held; and
   (d) the market value of each class of securities held and if the carrying value is other than average cost, the basis of valuation;

(4) that, subject to the following recommendations, the financial statements of a mutual fund in its annual report and prospectus should include a statement containing the following information as to transactions effected for its portfolio during the period reported on:

(a) particulars similar to those contemplated by clauses (a) and (b) of recommendation (3) with respect to each class of security held by the mutual fund at any time during the period reported on; and

(b) for each class of securities described pursuant to clause (a), the aggregate number (or the aggregate face value in the case of debt instruments) of securities of that class purchased during the period, with their total cost, and similar information as to securities sold during the period with the amount of the proceeds of sale;

the statement furnished pursuant to this recommendation should separate equity from debt instruments and should provide sub-totals for each;

(5) that for purposes of the statement furnished pursuant to recommendation (4) it should be permissible to aggregate transactions in debt instruments maturing within a year after purchase by the mutual fund, except for any such instruments issued by associates of the mutual fund as that term is defined in paragraph 9.32, recommendation (2);

(6) that it should be permissible to omit from the statement furnished pursuant to recommendation (3) information of the type contemplated by clauses (a), (b) and (c) of that recommendation with respect to securities the aggregate value of which does not exceed 5% of the total net assets of the mutual fund; the fact that securities are omitted should be indicated by the inclusion of a heading "miscellaneous securities" and the provision of the information contemplated by clause (d) of recommendation (3) on an aggregate basis for the omitted securities;

(7) that if, pursuant to recommendation (6), securities are omitted from the statement furnished pursuant to recommendation (3), it should be permissible to omit the same securities from the statement furnished pursuant to recommendation (5);

(8) that if information is omitted from a prospectus pursuant to recommendation (6) or (7), the omitted information should be provided in the next prospectus with an explanation of the reasons for the omission; if information is omitted from an annual report, a corresponding explanation should be provided in the next annual report; and

(9) that the financial statements of a mutual fund in the annual report and prospectus should include a statement containing the following information as to compensation paid to brokers or others in connection with investment transactions during the period reported on:

(a) total commission payments, subdivided between those paid with respect to transactions in common and preferred stock, and those paid with respect to transactions in debt instruments; it should be permissible to include a separate figure for commissions paid with respect to transactions in short-term debt instruments of the type described in recommendation (5); and

(b) total compensation of other types; if the figure provided is an estimate, the method of calculation should be explained.

Statement of Changes in Net Assets

15.48 Exhibit 15-C is a model form of a statement of changes in net assets. The submissions made to us, including that of the Canadian Institute of Chartered Accountants and that of the Canadian Mutual Funds Association are unanimous that this type of statement provides the best method to indicate changes in the position of a mutual fund during a period, although the submissions are not in complete agreement as to the exact contents of the statement. This form of presentation substitutes for a number of financial statements customarily used in other types of business enterprise, and frequently used by mutual funds. Such statements include statements of issued capital, paid-in surplus, undistributed income, realized gains or losses on investments, and unrealized appreciation or depreciation of investments.

15.49 In paragraph 15.20 we conclude that certain of the restrictive conditions which we propose for application where comparative statements are published on a voluntary basis should not be applicable with respect to a

one-year comparative statement of changes in net assets. The emphasis given in that statement to issues and redemptions of shares or units would make it less likely that changes attributable to those factors would mislead the reader. In addition, there are cases where the analyst can base conclusions of significance on changes in the flow of money to and from the mutual fund. These considerations have not been sufficient to induce us to recommend a requirement that comparative statements of changes in net assets be included in the financial statements, since the interested analyst can usually obtain a copy of comparative statements from reports published in prior years.

15.50 The Securities Act, 1966 was amended in 1967 by the addition of a new section 123a which requires a statement of changes in net assets somewhat similar to that set out in Exhibit 15-C. We have omitted certain items contemplated by that provision in our proposed form of statement. The statute requires that the statement of changes in net assets include statistics indicating the aggregate cost of portfolio securities owned at the beginning of the period, the cost of purchases during the period, and the cost of securities owned at the end of the period. We have not included these figures in Exhibit 15-C. The aggregate cost of securities owned at the end of the period will appear in the statement of net assets and shareholders' or unitholders' equity (Exhibit 15-B), and sufficient information as to the cost of and proceeds from securities purchased and sold during the period will appear in the statement of transactions proposed in paragraph 15.40. An interested analyst could obtain the remaining item, cost of securities owned at the beginning of the period, from the preceding report.

15.51 Section 123a also requires that the statement of changes in net assets include "distributions, showing separately the amount out of net investment income and out of realized profits". Exhibit 15-C would require a statement indicating total distributions. We believe that sufficient information as to the source of the distribution will be provided by the suggested five-year statistical summary discussed below. The only other item required by

EXHIBIT 15-C

(NAME OF MUTUAL FUND)

STATEMENT OF CHANGES IN NET ASSETS

FOR THE YEAR ENDED 19

	Year Ended	
Net assets at beginning of 19__ (including income available for distribution of $________)	$________	
Income:		
Net income for the year	$________	
Dividends paid to shareholders (unitholders)	$________	
Net increase (decrease) in income available for distribution	$________	$
Capital:		
Proceeds from the sales of ______ shares (units) during the period	$________	
Cost of ______ shares (units) redeemed during the period	$________	
Net proceeds (cost) of shares or units issued and redeemed	$________	
Realized profits (loss) on sale of investments	$________	
Increase (decrease) in unrealized appreciation of investments	$________	
Net increase (decrease) in capital	$________	$________
Net assets at end of year (including income available for distribution of $________)	$________	

section 123a to be included in the statement of changes in net assets that is not reflected in Exhibit 15-C is certain information on a per share or unit basis. This type of information is considered in the following subsection, where we discuss the five-year statistical summary which we propose should be required in the financial statements.

15.52 For the reasons set out in this section, we recommend:

> that the financial statements of a mutual fund in its annual report and prospectus should include a statement of changes in net assets containing the information contemplated by Exhibit 15-C.

Five-Year Statistical Summary on a Per Share or Unit Basis

15.53 Exhibit 15-D is a model form of a five-year statistical summary on a per share or unit basis. This exhibit, more than any of the others, is applicable specifically to mutual funds and would be inappropriate for other types of enterprise. Because of this, and because there are items which it would seem desirable to include in the five-year statistical summary, but which are omitted from Exhibit 15-D for technical reasons, it seems desirable to review the reasoning which underlies the conclusions reflected in that exhibit.

15.54 To the average shareholder or unitholder of a mutual fund, by far the most meaningful and important financial information is that which is stated on a per share or unit basis. Growth in net asset value per share or unit is of infinitely greater importance to him than is growth in the total net assets of the mutual fund. It would be very desirable to have complete information expressed on a per share or unit basis, and this is one type of information which could be of even greater value if expressed on an historical basis for comparative purposes. In its brief to us, the Canadian Institute of Chartered Accountants adopted this approach, recommending that mutual funds be required to provide five-year statistical summaries on a per share or unit basis, and that such summaries should distinguish severally at least the following information for a share or unit outstanding throughout each period:

EXHIBIT 15-D

(NAME OF MUTUAL FUND)

PER SHARE (UNIT) STATISTICAL SUMMARY OF A SHARE OR UNIT OUTSTANDING THROUGHOUT THE PERIOD

Year Ended	Net Asset Value at Start of Year	Distributions during year		Excess of Realized and Unrealized Capital Gains (Losses) and Income over Expenses and Distributions	Net Asset Value at End of Year
		Capital	Dividends Paid		
19__					
19__					
19__					
19__					
19__					

Notes:

1. Where a share (unit) split or consolidation or stock dividend has occurred during the five years, all information should be adjusted so that it is properly presented on a current basis.

2. Share (unit) dividends should be reflected at net asset value at the record date.

3. The amount to be shown as distributions of capital will be zero in any year when all distributions actually made could have been made from income earned during the year or accumulated during prior years. In any year when that is not the case, distributions of capital will bear the same proportion to total distributions per share or unit that the excess of the aggregate amount distributed over available income bears to the aggregate amount distributed. For example, if total income earned during the year and available from prior years is $5,000,000; the amount distributed is $6,000,000, the total number of shares outstanding is 2.5 million and total distribution per share or unit is $2.40, capital distribution per share or unit is $0.40. An explanation should be provided for any year with respect to which net asset value per share or unit at the beginning of the year, less distributions, plus the excess of capital gains and income over expenses and distributions, does not equal net asset value per share or unit at the end of the year.

(a) net asset value at the beginning of each period
(b) dividends, interest and other income from investments
(c) expenses other than income taxes
(d) income taxes
(e) net income
(f) dividends paid
(g) net realized and unrealized gain (loss) on investments, and
(h) net asset value at the end of each period.

15.55 We were attracted by the recommendation of the Canadian Institute of Chartered Accountants; information of the type recommended by it would be of considerable interest to present shareholders and unitholders and to potential purchasers. We have, however, concluded that there would be difficulty, in some cases insuperable difficulty, in arriving at the necessary information with respect to a mutual fund continuously engaged in the issuance and redemption of shares or units. It is noteworthy that only three of the specified items are clearly determinable by reference to readily ascertainable information, net asset value per share or unit at the beginning and end of the period, and distributions during the period; the latter item can be subdivided between capital and income distributions in the manner described in note 3 to Exhibit 15-D. A fourth figure can be determined by deducting from net asset value per share or unit at the end of the period the aggregate of net asset value per share or unit at the beginning of the period and distributions during the period (whether in cash or in shares or units). This fourth figure can be taken as an expression on a per share or unit basis of the amount by which undistributed gains, including income and realized or unrealized capital gains, exceeded expenses for the period. While the latter item might arguably not be accurate with respect to a share or unit outstanding throughout the year (if, for example, the number of shares outstanding on dividend payment dates were, on average, much higher or much lower than the average number outstanding during the year) we think it is a significant figure the disclosure of which would be appropriate. Disclosure of these four items on an historical basis would clearly be feasible, but they do not include several items recommended by the Institute of Chartered Accountants which are of almost equal importance. The most important of the latter items are sources of income and types of expense on a per share or unit basis.

15.56 Several mutual funds presently provide information of the type recommended by the Institute of Chartered Accountants, and mutual funds subject to section 123a of The Securities Act, (Ontario) are required to show not only net asset value per share or unit at the beginning and at the end of the period, but also distributions per share or unit out of net investment income and out of realized profits. We have considered the methods currently used to provide this information, and whether one of these methods or some other method might be capable of general application so that the items recommended by the Canadian Institute of Chartered Accountants but not included among the four items referred to in the preceding paragraph could be provided on a reliable and uniform basis. We have been unable to find any such method. All the information is so seriously affected by fluctuations in number of shares or units outstanding that, we have concluded, there is no fair and meaningful way to calculate these additional items that would be appropriate for all mutual funds. Those mutual funds that presently supply this information make use of assumptions which, while accurate for them, are not of general application. One, for example, distributes annually all its net income by way of dividends. A per share statistical summary is included in its financial statements which is prepared on the assumption that net income on a per share basis for a share outstanding throughout the period equals the dividends paid on that share. This assumption may be subject to question, and is certainly not one of general application.

15.57 We have considered variants of the methods presently followed, one such variant being to compute each item of information daily and to aggregate the daily totals at the end of the year. Apart from the difficulties in implementation of such an approach, for a great many calculations would be required, we think that the result might cause more confusion than it would resolve for the information expressed would not necessarily coincide with the actual experience of the holder of a share or unit outstanding throughout the period. Having rejected all available methods for the determination of income or expenses on a per share or unit basis, we have been forced to the conclusion that the kind of detailed statement recommended by the Canadian Institute of Chartered Accountants cannot feasibly be required by statute. Exhibit 15-D

therefore embodies only the four items of information referred to in paragraph 15.55, with distributions during the year subdivided between capital and income distributions in the manner described in note 3 to Exhibit 15-D. The latter subdivision is of particular importance in view of the fact that implementation of our conclusions in Chapter V would remove any restriction on dividends or other distributions made by the mutual fund from capital.

15.58 One addition to the information described above should be made with respect to incorporated Canadian mutual funds. For income tax purposes, these mutual funds must be in a position to state whether they have distributed all of their income during the year and to state the amount of undistributed income on hand on a per share basis at the end of year; they must also be able to state the amount of undistributed income on hand on a per share basis with respect to any share redeemed during the year, as of the time it was redeemed. Methods for the determination of this information vary and the Department of National Revenue has recognized the difficulties it involves. Still, the information is of considerable importance to shareholders and we think that it should be provided in the per share statistical summary. We have concluded that incorporated mutual funds should provide, as part of the summary or by way of note thereto, a statement of the undistributed income per share on hand at the end of each year covered by the summary.

15.59 Some mutual funds may elect to present the additional per share or unit information recommended by the Canadian Institute of Chartered Accountants, or similar information. This may be perfectly feasible in some situations, particularly with a mutual fund whose total number of shares or units outstanding has remained relatively constant throughout the year. We have concluded that additional information on a per share or unit basis should be permitted if the method of calculation is indicated and the auditor's report specifies that the entire statement presents fairly the information it purports to present.

15.60 For the reasons set out in this section, we recommend:

(1) that the financial statements of a mutual fund in its annual report and prospectus should include a five-year per share or unit statistical summary for a share or unit outstanding throughout the period containing the information contemplated by Exhibit 15-D and the notes thereto;

(2) that incorporated mutual funds should provide as part of the summary furnished pursuant to recommendation (1), a statement of the undistributed income per share on hand at the end of the year covered by the summary; and

(3) that it should be permissible for the financial statements of a mutual fund to include information on a per share or unit basis in addition to that contemplated by Exhibit 15-D if the method of calculation of such information is clearly indicated and if the auditor's report thereon specifies that the statement in which such information is included presents fairly the information it purports to present.

Semi-Annual Reports

15.61 In paragraph 14.120 we conclude that mutual funds should be required to distribute semi-annual reports to the holders of their shares or units. The financial statements contained in this report should provide information similar to that which we propose for inclusion in the annual report. Those statements, such as the statement of income and expenses, which provide information for a period rather than at a specific date should relate to the six-month period elapsed since the date of the preceding annual report. Such a requirement would be inappropriate for many organizations which carry on other types of activity, since seasonality of income or expenses might affect the results. That is not ordinarily a major problem with mutual funds but the statements in the semi-annual report should be accompanied by an explanatory note

if management believes that the results for the six-month period reported on are significantly affected by seasonality. Explanatory notes should also deal with any other ways in which the financial statements might mislead as a result of the provision of information for a period of six months rather than a year.

15.62 For the reasons indicated in paragraph 6.81, we have concluded that an auditor's report should not be required to accompany the financial statements in semi-annual reports. Instead, the semi-annual report should contain a certificate of two responsible officers of the mutual fund or of its management company to the same effect, with any necessary changes, as the auditor's report proposed in paragraph 6.82.

15.63 In the semi-annual report as in the annual report, material in addition to the required information is often included, to assist sales or for other reasons. We have concluded that such information should be permitted subject to the same conditions under which additional information is permitted in annual reports and prospectuses. Compliance with the guidelines for sales literature formulated pursuant to paragraph 14.73 would be required in all cases. Compliance with the restrictions outlined in paragraph 15.20 would be required if comparative financial statements were used.

15.64 It is desirable to comment briefly on the use of certain statements in the semi-annual report. Representatives of the mutual fund industry have contended that the statement of income and expenses (Exhibit 15-A) would not be meaningful in a semi-annual report except for a mutual fund whose investment objectives place emphasis on income. We do not accept this contention, for the statement of income and expenses reflects expenses as well as income and the former are relevant regardless of the objectives followed in portfolio management concerning production of income. It is only from the statement of income and expenses that an accurate idea of the amount and nature of expenses can be obtained.

15.65 The statement of net assets and shareholders' or unitholders' equity (Exhibit 15-B) and the various statements as to portfolio content and trading proposed in paragraphs 15.34 to 15.46 require no additional comment

here. The statement of changes in net assets (Exhibit 15-C) could be misleading in a semi-annual report unless a clear explanation is provided of the fact that it relates only to a six-month period. Mutual funds which pay dividends but do not make a policy of paying them in equal amounts in the first half and the second half of the year should include in the explanation a statement of this fact and of the anticipated dividend policy for the six months following the date as of which the report is made. This explanation should be so worded and so located that it will appear as a note to the statistical per share or unit summary as well as to the statement of changes in net assets.

15.66 The five-year per share or unit statistical summary included in the semi-annual report should consist of the information for the five years ending with the date of the preceding annual report, plus similar information for the six months reported on in the semi-annual report. The former would ordinarily be identical to the corresponding statement in the preceding annual report; the latter, which should be so presented as to indicate clearly that the period it covers is six months rather than a year, should also follow the form of Exhibit 15-D with any necessary adjustments.

15.67 For the reasons set out in this section, we recommend:

(1) that semi-annual reports of mutual funds should include the same financial information as that recommended for inclusion in annual reports; financial statements which contain information for a period rather than at a specific date should relate to the six-month period since the date of the preceding annual report;

(2) that an explanatory note to accompany the financial statements in a semi-annual report should deal with any ways in which the financial statements might mislead as a result of the provision of financial information for a period of six months rather than a year; in particular, an explanatory note should be provided if it is anticipated that the results may be affected by seasonality;

(3) that the financial statements in a semi-annual report should be accompanied by a certificate of two responsible officers of the mutual fund or its management company to the same effect, with any necessary changes, as the report of the auditor made on an annual report in accordance with the recommendation contained in paragraph 6.88;

(4) that material in addition to the required information should be included in semi-annual reports only if it complies with the conditions proposed for the inclusion of similar information in annual reports;

(5) that the statement of changes in net assets in a semi-annual report should be accompanied by a clear explanation that it relates only to a six-month period, which explanation should be so worded and so located that it will appear as a note to the five-year statistical summary as well; if the mutual fund pays dividends and does not make a practice of paying them in equal amounts in the first and second halves of the financial year, the explanation should also include a statement of this fact and of the anticipated dividend policy for the six-month period following the date as of which the semi-annual report is made; and

(6) that the five-year per share or unit statistical summary should consist of the information required in that statement for the five years ending with the date of the preceding annual report, and similar information for the six months reported on; the latter information should be so presented as to indicate clearly that the period it covers is six months rather than a year.

Quarterly Reports

15.68 As indicated in paragraph 14.120, we do not propose that mutual funds should be required to publish quarterly reports. However, we think it appropriate in cases where such reports are published on a voluntary basis, to specify appropriate restrictions as to their contents. In case where they include financial statements similar to any of those which we propose for inclusion in annual and semi-annual reports, the rules governing such

financial statements should be applicable. In addition, the guidelines on the content of sales literature and the restrictions on the use of comparative financial statements should apply to quarterly reports as they would to semi-annual reports under paragraph 15.63. Financial statements which related to a period rather than to a specific date could apply either to the quarter reported on or to the period since the preceding annual report; this would mean that the quarterly report for the first quarter would cover a three-month period, while that for the third quarter would cover either a three or a nine-month period.

15.69 For the reasons set out in this section, we recommend:

(1) that in cases where quarterly reports are published and include financial statements similar to any of those required for inclusion in annual and semi-annual reports, they should conform with the restrictions applied to those reports.

(2) that the content of quarterly reports should conform with guidelines for sales literature prepared in compliance with paragraph 14.79, and comparative financial statements should be included only subject to compliance with the restrictions in paragraph 15.21, recommendation (4); and

(3) that financial statements in a quarterly report which relate to a period instead of a specific date should be either for the quarter reported on or for the three or nine months since the date of the preceding annual report.

Mutual Funds Investing Exclusively in Shares or Units of Another Mutual Fund

15.70 A number of mutual funds whose shares or units are qualified for sale in Canada, invest exclusively in the shares or units of a single other mutual fund, with the former mutual fund sometimes colloquially referred to as the "top" fund and the latter as the "bottom" fund. This arrangement is frequently adopted for income tax reasons in connection with the sale in Canada of shares of mutual funds organized in the United States or elsewhere outside

Canada. In addition, it is used where the organizers wish to cater with a single investment portfolio for investors who are interested in dividend payments and for those who prefer to let their money accumulate. These arrangements are often referred to as compound funds, although that term is more appropriate for mutual funds in the latter of the two categories than for those in the former. In paragraph 12.90 we distinguish these mutual funds from "funds on funds" which invest in a variety of mutual funds as an investment technique.

15.71 It is apparent that the disclosure requirements applicable to compound funds must be somewhat different from those for ordinary mutual funds. We comment on this point in paragraph 14.65 and make specific suggestions concerning the disclosure requirements that we think appropriate in this situation. So far as financial disclosure is concerned, we have concluded that the prospectuses and reports of the "top" fund should be required to contain financial statements of the "bottom" fund identical to those which would be required if the prospectus or report were prepared with respect to the "bottom" fund. In addition, prospectuses and reports of the "top" fund would be required to include a five-year statistical summary on a per share or unit basis as contemplated by Exhibit 15-D and a statement of net assets and shareholders' or unitholders' equity as contemplated by Exhibit 15-B, both with respect to the "top" fund itself.

15.72 For the reasons set out in this section, we recommend:

> that the prospectuses and reports of a mutual fund which invests exclusively in the shares or units of another mutual fund should include the financial information which the latter mutual fund would itself be required to provide, but with respect to the former mutual fund should only be required to include its own five-year per share or unit statistical summary and its own statement of net assets and shareholders' or unitholders' equity.

CHAPTER XVI

BANKS; TRUST COMPANIES; LIFE INSURANCE COMPANIES; FOREIGN MUTUAL FUNDS

16.01 Representatives of the organizations traditionally known and referred to as mutual funds have urged us to adopt the approach that any arrangement which resembles a mutual fund should be so regulated. Were we working on a blank slate, this might be feasible. The fact that our proposals must be implemented in the context of a developed economy and of existing financial institutions imposes two constraints which must be taken into account. The first is the difficulty in making a sharp distinction between arrangements which resemble mutual funds, and should be so regulated, and those which do not. The discussion in Chapter V exemplifies this problem. The mutual fund is a vehicle for the provision of a withdrawable equity interest in a portfolio of investments, and there are many arrangements of which that statement is more or less true. It would not be desirable to state arbitrarily that the regulatory scheme proposed in this report should apply in its entirety to some of the arrangements, and be in no way applicable to others. It would not be feasible to say that the scheme should apply in its entirety to all the arrangements.

16.02 The second constraint on the attempt to apply the mutual fund regulatory scheme to all arrangements which resemble mutual funds arises from the fact that some of them are sponsored by financial institutions which are already subject to detailed regulations. To the extent that those regulations accomplish the objectives of recommendations made in this report, it would be pointless to duplicate the existing requirements through application of the

regulations we propose. This is an important point since all financial institutions share certain common characteristics and it is therefore natural that the regulations applicable to them should share some common objectives.

16.03 In spite of our recognition of the two constraints, we agree in principle with the position that all arrangements which resemble mutual funds should be so regulated. In Chapter V we propose a definition designed to identify such arrangements. As a consequence of the two constraints described in the preceding paragraphs, the line drawn by the definition does not mark an obvious separation between types of financial instruments. For example, the definition includes investment funds offered for public participation by trust companies, but it does not include funds sponsored by trust companies to provide the basis for retirement savings plans registered under the Income Tax Act. Nor does it include variable policies of life insurance companies and the segregated funds upon which they are based, although we recognize that these are directly competitive with mutual funds.

16.04 Given the lack of an obvious line of separation between mutual funds and other financial arrangements, it is a natural result that the regulatory scheme should require adjustment to the various arrangements. Some of those caught by the definition should be granted limited exemptions from parts of the scheme; others should be made subject to parts of the scheme even though they are not caught by the definition. Examples of the former include the trust company investment funds, and may include certain foreign mutual funds and certain aspects of the distribution of mutual funds through chartered banks. The most important examples of the latter, stressed in Chapter V, are the individual variable policies of life insurance companies and the segregated funds upon which they are based.

16.05 In this chapter we discuss the four examples mentioned above, of arrangements not caught by the definition which should nevertheless be made subject to parts or all of the regulatory scheme and of arrangements caught by the definition for which exemptions are appropriate. These examples are of considerable substantive importance, since the plans and arrangements which

would be affected by the implementation of the proposals in this chapter are already of substantial size and their continued growth seems likely. The discussion should not, however, be looked to merely for the specific proposals made, but as illustrative of the method of approach that should be adopted for other financial instruments which may develop in the future. It would be impossible to predict the nature of these instruments, or the details of the regulations which would be appropriate for them. If the responsible authorities analyze each new instrument in the way that existing instruments are analyzed in Chapter V and in this chapter, we believe that the result will be an effective scheme for the protection of the investor, applied on a consistent basis, while preserving flexibility for the development of new financial instruments.

16.06 In the following sections we consider first the distribution of mutual funds through banks. We then discuss the trust company investment funds and the segregated funds of life insurance companies. Finally, we consider the regulation of foreign mutual funds which are distributed in Canada.

Banks

16.07 The development of relationships between Canadian chartered banks and mutual funds is a controversial topic upon which we have received a number of submissions. To put the matters in issue into perspective it is necessary to review the nature of the relationships which have developed. All are attributable to the same considerations. The banks have large numbers of customers, many with cash readily available. For at least some of these customers, the mutual fund would be an ideal vehicle for investment. In addition, the major Canadian chartered banks have extensive branch banking systems which provide them with a degree of access to the Canadian public that is probably unmatched by any other type of financial institution; this is particularly true in rural areas. One consequence of the branch banking system is described as follows in a brief we received from a mutual fund associated with a chartered bank:

> ... in countless individual cases the local bank manager has habitually been looked upon as being the financial advisor to his clients,

many of whom will take no financial action without discussing it with him...*

For all these reasons, it is understandable that a bank should wish to establish a relationship with a mutual fund in order to make shares or units available to its customers.

16.08 At the time of writing, two of the major Canadian chartered banks are in a position to make available to their clients the shares of associated mutual funds, and a third, smaller, bank is also associated with a mutual fund. The arrangements differ considerably. The Toronto-Dominion Bank and Loomis-Sayles, Inc., a large mutual fund management organization in the United States, each own 50% of Corporate Investors (Marketing) Limited and of Loomis-Sayles and Co. (Canada) Ltd. The latter two companies are, respectively, the distribution company and the management company of Corporate Investors Limited, although the contractual arrangements are somewhat unusual in that Loomis-Sayles and Co. (Canada) Ltd. acts under a contract with Corporate Investors (Marketing) Limited rather than with Corporate Investors Limited.

16.09 The basic sales charge rate for shares of Corporate Investors Limited is the prevailing rate of approximately 8.5% and The Toronto-Dominion Bank collects the normal commission paid to brokers on sales of those shares. It therefore benefits both from management fees and from sales charges. In addition, it owns an underlying class of common shares of Corporate Investors Limited, which give it the right to elect three of the twelve directors of the mutual fund, although it does not exercise that right. Certain of the directors and officers of The Toronto-Dominion Bank are, however, directors of Corporate Investors Limited. Finally, The Toronto-Dominion Bank acts as custodian of the assets of Corporate Investors Limited.

16.10 The other mutual fund associated with a major Canadian chartered bank is RoyFund Ltd., a name obviously derived from that of its associated bank, The Royal Bank of Canada. The Royal Bank of Canada has no participation either in the management company, United Bond and Share Limited, or the distri-

* United Bond and Share Limited, RoyFund Distributors Ltd. and RoyFund Ltd.; Brief to the Canadian Committee on Mutual Funds and Investment Contracts (June, 1968) page 18.

bution company, RoyFund Distributors Ltd., of RoyFund Ltd.; the distribution company is a wholly-owned subsidiary of United Corporations Limited, a closed-end investment company. Applications for shares are accepted only by the distribution company, but forms and information are available at branches of The Royal Bank of Canada. This is the only important technique used to effect their distribution; they are not sold through other sales outlets. The basic sales charge rate is 3% of the net asset value of shares or units purchased, or about 2.91% of the amount paid by the purchaser; no part of this charge is paid to The Royal Bank of Canada.

16.11 While the Royal Bank does not participate in the management company or the distribution company of RoyFund Ltd. and receives no compensation for the sale of shares, it is closely related to the mutual fund in other ways. The bank acts as custodian of the portfolio securities of the mutual fund, and as transfer agent (but not registrar) for its shares. In addition, by arrangement with the management company, the bank performs clerical and accounting functions for which services it receives a portion of the management fee paid by RoyFund Ltd.

16.12 The third chartered bank which is associated with a mutual fund is The Mercantile Bank of Canada. This bank is a subsidiary of the First National City Bank of New York, as is International Trust Company. The latter company has organized Investoflex Fund as a trust company investment fund, sold without sales charges. The Mercantile Bank of Canada makes units of this mutual fund available to its customers, but does not advertise them to the extent that is done by the two chartered banks discussed in preceding paragraphs. Because of that, and because The Mercantile Bank of Canada lacks the extensive network of branches which characterizes The Toronto-Dominion Bank and The Royal Bank of Canada, the relationship between The Mercantile Bank and Investoflex Fund is not of the same significance as the other relationships described above.

16.13 In spite of the diversity of arrangements between the chartered banks and their associated mutual funds, they have two common features which are of considerable importance to the following discussion. The first is that

in each case the mutual fund is organized separately from the bank, and has its own management company. This is an important difference from life insurance companies and trust companies. The segregated funds of life insurance companies and the investment funds of trust companies are regarded by the respective companies as accounts maintained by them rather than as separate entities. These accounts are entirely managed by the companies concerned. The fact that the banks have not organized accounts in a similar way is attributable in large part to doubts concerning the extent of their legal powers. It is not clear whether Canadian chartered banks are permitted to sell investment advice, and the power to do so would be essential if the banks were to manage funds in a manner similar to life insurance companies and trust companies.

16.14 Because banks and their associated mutual funds are operated as separate entities in law and in fact, it is appropriate to consider the banks only as sales outlets for the mutual funds. There is no reason to confer special treatment on a mutual fund merely because it is associated with a bank, except to the extent that such treatment may be appropriate for the bank in its sales function. Here the second similarity of the three cases described above is relevant. None of the three banks has salesmen engaged exclusively in the distribution of mutual funds. Indeed, all emphasize that their employees receive no benefit from the sale of shares or units in the associated mutual fund, and that the employees are therefore not reluctant to discuss other mutual funds with potential purchasers. Both The Toronto-Dominion Bank and The Royal Bank of Canada display literature in their branches to advertise their associated mutual funds. The advertising is their only major effort to find customers apart from the existing clients of the bank.

16.15 The controversy concerning bank-mutual fund relationships revolves around two principal contentions. It is said, first, that banks should not be permitted to establish associations with mutual funds at all. Second, if the first contention is rejected it is said that banks should be in no way exempt from the requirements applicable to other sales outlets; their employees should be required to register and to take training courses as do mutual fund salesmen. Two arguments are advanced in support of the first

contention. It is said first that, in view of the role of the bank manager as financial adviser which is noted in the quotation in paragraph 16.07, it is undesirable for bank managers to be put in a position where it is necessary for them to "push" a particular mutual fund. Such a position raises the possibility that the manager will abuse his relationships with his customers and his knowledge of their personal financial affairs to sell them mutual fund shares or units.

16.16 The argument that a relationship between a chartered bank and a mutual fund puts a branch manager in a position where his duty to his customer conflicts with his duty to his employers is supplemented by related points concerning sales through banks. It is said that the branch banking system provides the chartered banks with an unfair competitive advantage. The branches constitute a readily available distribution network since they can readily add the sale of mutual fund shares or units to their other activities at small marginal cost. In addition, apart from the conflict of interest question, it is said that bank employees lack the requisite experience and knowledge to advise customers concerning mutual fund investments.

16.17 The second argument advanced in support of the contention that chartered bank-mutual fund relationships should be prohibited is summarized in the brief from which the quotation in paragraph 16.07 is extracted:

> ...One possible argument that might be advanced against an association between chartered banks and mutual funds might...run along the lines that, if banks were to control the resources of large mutual funds in addition to the enormous assets they already administer, they might be in a position to control large segments of the Canadian economy and use this control against the best interests of the Canadian public in general and the shareholders of the controlled funds in particular.*

16.18 Any alleged competitive advantage to the banks would alone have little merit, in our view, as an argument against relationships between them and mutual funds. The development of competition among Canadian financial institutions would be stultified if institutions of one type could not issue instruments of a new kind because they would have a competitive advantage over institutions of another type. The argument that bank managers might unfairly

* Supra, footnote to paragraph 16.07, page 15.

use their position to sell mutual funds concerns us not for that reason but because of the potentiality of a conflict of interest. There are obvious problems in the reconciliation of the duty of a bank employee to give impartial investment advice to his customers with his duty to the bank to sell shares or units of an associated mutual fund, regardless of the extent to which the bank may stress that the employee is not to give undue weight to the mutual fund concerned. On the other hand, it may well be that the availability of an associated mutual fund will enable the bank to give better service to its clients. We have concluded that the decision whether to become associated with a mutual fund should be regarded as a matter of business judgment for the bank, but that the clearest possible disclosure of the relationship should be made to the customer when he is advised by a bank employee to invest in an associated mutual fund. Proposed requirements for the nature and content of this disclosure are outlined below. The argument that bank employees lack the knowledge and experience to advise customers concerning mutual funds is also dealt with below, in our conclusions concerning the training of bank employees.

16.19 The argument described in the quotation in paragraph 16.17, that relationships with a mutual fund may concentrate undue economic power in the hands of a chartered bank, involves important questions of national economic policy and of the appropriate role for chartered banks. The brief from which the quotation is taken comments that there is no reason to assume that the banks would exercise their power in anything other than a fair and responsible manner, and we do not quarrel with this statement although it does not necessarily constitute an adequate rebuttal of the argument. The economic and other questions involved in a resolution of this argument have implications that far exceed our purview, and we therefore can base no conclusions on it. For that reason, and because we reject the other arguments advanced to support it, we also reject the contention that relationships between banks and mutual funds ought to be prohibited.

16.20 The second contention advanced in the controversy concerning bank-mutual fund relationships has been pressed on us by many who have made submissions. To the time of writing the provincial securities administrators

have not required employees of chartered banks to register or to take training courses in connection with their sale of mutual funds. There are four principal reasons for this position. The administrators are concerned with possible constitutional implications since the regulation of banks and banking is a federal responsibility. Second, exemptions from the registration requirements in most of the provincial securities acts may be construed to make these requirements inapplicable to the banks. Third, the administrative problems involved in the determination of what bank employees should be registered and in having them take a training course might be considerable. Fourth, the administrators recognize some merit in an argument advanced by the banks which is stated as follows in a letter written to us on behalf of The Toronto-Dominion Bank:

> Topic No. 5 [in a request for written submissions circulated by the Committee] also raises the question of the requirements to be satisfied by personnel selling shares of mutual funds. Training programmes for branch officers engaged in the sale of mutual fund shares are conducted by the bank. No officer below the rank of administration officer (accountant) is permitted to enter into detailed discussion on investment matters or to accept orders. Wherever possible prospective purchasers are interviewed by the bank manager. In other words, only senior branch personnel can promote sales; in the majority of branches the manager and administration officer; in larger offices, managers, assistant managers and accountants. It is hardly necessary for us to point out that all of these officers have years of experience in financial matters and have readily available to them the expertise, advice and counsel of the bank's head office Investment Division. As a matter of policy the bank only promotes the sale of mutual fund shares where investment in such shares is appropriate to the financial circumstances and investment objectives of the individual. Investors who prefer, or whose financial needs dictate, the security of bonds and savings deposits are not encouraged to exchange their holdings for mutual fund shares.*

16.21 Of the four reasons for the non-application of registration and training requirements to bank employees, each of the first three is either irrelevant to us or is unconvincing. Constitutional considerations need not deter us from recommendations for appropriate procedures since we report to the federal as well as to the provincial governments. Interpretation of the existing legal position is not a determinative factor, since we are able to recommend changes in the law. The administrative difficulties in the applications of a registration requirement can, we think, be readily surmounted. The fact that employees of the banks are frequently moved from province to province would

* Letter from The Toronto-Dominion Bank to G.E. Grundy, July 26, 1968.

occasion considerable difficulty if the rules applied in each province were different, but it is our hope that our recommendations will result in uniform requirements across Canada. As to the difficulty in the determination of which employees should register and take the training course, the quotation in the preceding paragraph sufficiently indicates that the banks feel able to designate what employees will advise customers concerning mutual funds; this point is considered more specifically below.

16.22 The fourth reason, represented by the quotation in paragraph 16.20, is the principal one relied upon by representatives of the banks in our conversations with them. Their feeling is that by the time an employee has reached a senior level in the branch banking system, he has acquired sufficient knowledge to be able properly to advise customers; the knowledge is attributable both to his own working experience and to courses given by the banks. We recognize that the manager of a bank branch can be viewed in a different way from a new mutual fund salesman with no previous experience; the character references and inquiries which form part of the registration process in the latter's case are probably not necessary for the former. We cannot, however, agree that a person is necessarily qualified to engage in the sale of mutual fund shares or units simply because he has attained a position of seniority in a bank branch.

16.23 The knowledge and experience gained by a person during his rise to the level of accountant or branch manager in a bank, while of great value to him in his ordinary work, is unlikely to include extensive exposure to the merits of equity investments. A brief review of either the Canadian Securities Course or the Canadian Mutual Funds Course shows many items which are unlikely to arise during normal banking activities. Our concern that this may result in accountants or branch managers who know little of equity investments purporting to advise their clients on such investments is accentuated by the fact, pointed out in the quotation in paragraph 16.07, that the managers of branches are habitually looked to by many of their clients for financial advice. The possible consequences are apparent; the manager to whom the customer looks for

advice, but who is not personally versed in the intricacies of the equity markets is likely to recommend the mutual fund associated with his own bank without full consideration of alternatives.

16.24 It might be said that bank customers do not need the protection which is available through the application of a registration and training requirement since a bank employee is unlikely to engage in active promotion of a mutual fund and customers can therefore be assumed to be persons for whom mutual funds are shopping goods. We have concluded that our proposal in paragraph 14.15 that exemptions from the registration and training requirements should be granted to salesmen associated with organizations which levy no sales charges and have no salesmen "on the road" goes as far as is appropriate to meet this argument. A bank which sells shares or units, or arranges for their sale, with a sales charge levied may engage in an active promotional campaign, and we think that it would be inaccurate to assume that the purchasers would all be persons for whom shares or units of mutual funds are shopping goods. In some circumstances the exemption would even be inappropriate for a bank which sold shares or units with no sales charge, and the administrator should then withhold the exemption as proposed in paragraph 14.15.

16.25 For the reasons indicated in the preceding paragraph we have concluded that, in principle, employees of banks should not (except to the extent contemplated by paragraph 14.15) be exempted from the registration and training requirements applicable to mutual fund salesmen. This conclusion does not resolve the problems to be considered, for it leaves open the question of who should be registered and of whether any differences should be made in the applicable requirements from those for other mutual fund salesmen. The registration requirement should, in our opinion, not apply where the employee merely gives investment advice and neither he nor the bank derives any advantage, direct or indirect, from the purchase. If the only relationship of the bank to the mutual fund is as custodian or transfer agent, the bank and the employee should not be considered to derive any such advantage. Any closer relationship should ordinarily be sufficient to result in indirect gain to the bank from the sale of shares or units. For example, we would include a relationship such

as that between The Mercantile Bank of Canada and Investoflex Fund, where the gain accrues to a parent company rather than to the bank itself; in that specific instance, however, the requirements for an exemption proposed in paragraph 14.15 are probably satisfied. The administrator should have authority to determine when the bank-mutual fund relationship is sufficiently close to justify the application of the requirement.

16.26 In cases where the registration requirement applies, recognition should be given to arrangements such as that described in the quotation in paragraph 16.20, under which only certain employees may discuss mutual fund investments with clients. If such arrangements exist, only those employees should be required to register and to take the training course. If the legislation is provincially administered, arrangements should be made which will permit an employee, once registered and while he continues to be associated with the same bank, to transfer across provincial boundaries without undue formalities. This would be desirable in all cases, but is particularly important for banks because of the frequency with which their employees are transferred. For this reason, and because of constitutional considerations, it would seem desirable that these requirements be nationally administered even if other training requirements are provincially administered.

16.27 We do not propose that bank employees who register under the proposals in the preceding paragraphs should, necessarily, be required to take the Canadian Securities Course or the Canadian Mutual Funds Course. The banks may be able to establish to the satisfaction of the appropriate administrator that the courses they currently give to their employees are adequate for the purpose, or may revise their courses so they will be adequate. Alternatively, the banks concerned may co-operate in the development of a special course to be used by each of them. The appropriate administrator should be receptive to reasonable proposals from the banks as to the procedures to be followed, for it is probable that their needs will be different from those of mutual fund distribution companies.

16.28 We comment in paragraph 16.18 on the importance of clear disclosure of the relationship between banks and mutual funds. At the time of writing, adequate disclosure is prevented by subsection 157(2) of the Bank Act, which prohibits, subject to exceptions not relevant here, the use of "the name of a bank in a prospectus or advertisement for the sale of securities". A number of submissions have been made to us concerning the desirability of this provision, but we make no comment on its general application. We have concluded that it should be modified to permit disclosure to bank customers of relationships between chartered banks and mutual funds. If the relationship between a bank and a mutual fund is such that the registration requirement would apply to the bank's employees (whether or not they are exempted from registration under paragraph 14.15) then every prospectus, every summary prospectus, every piece of sales literature and every advertisement concerning that mutual fund which is displayed in the bank or given by its employees to its customers should include a clear statement of the relationship between the bank and the mutual fund. Similar statements should be included in any such material used elsewhere which indicates or implies a connection of the bank with the mutual fund other than that of transfer agent or custodian, and in confirmations of purchases effected through the bank. These requirements should suffice to ensure that customers are alerted to the interest of the bank and to the consequent possibility that advice received might not be altogether impartial.

16.29 For the reasons set out in this section, we recommend:

(1) that, subject to the proposal in paragraph 14.25, recommendation (1) for exemptions in cases where sales are to purchasers for whom mutual funds are shopping goods, employees of banks should be required to register and to take a training course in order to participate in sales of mutual fund shares or units, if either the employee or the bank would make a direct or indirect gain as a result of the purchase; there should be no registration requirement merely because the employee gives investment advice if neither the employee nor the bank will gain from the purchase, which should be considered to be the case if the bank is related to the mutual fund only as custodian or transfer agent;

(2) that the administrator should have authority to determine whether the relationship between a bank and a mutual fund is such as to necessitate the application of the registration requirement proposed in recommendation (1);

(3) that in any case where the registration requirement proposed in recommendation (1) is applicable, and the bank requires that only specified employees discuss mutual funds with customers, the registration requirement should be limited to such employees;

(4) that, if the legislation is provincially administered, arrangements should be made which will permit an employee, once registered and while he continues to be associated with the same bank, to transfer across provincial boundaries without undue formalities; because of the importance of this freedom of transfer, and for constitutional reasons, it would be desirable for these registration requirements to be nationally administered even if other registration requirements are provincially administered;

(5) that registrants who are bank employees should be required to take and to pass an appropriate course, which could be the Canadian Securities Course or the Canadian Mutual Funds Course, but the administrator should be receptive to reasonable suggestions for alternatives including a course organized by a single bank or by banks in combination; and

(6) that if the relationship between a bank and a mutual fund is of the type described in recommendation (1), whether or not the employees of the bank are exempted from registration under paragraph 14.25, recommendation (1), then a clear statement of the relationship between the chartered banks and the mutual fund should be included in:

   (a) every prospectus, every summary prospectus, every piece of sales literature and every advertisement concerning that mutual fund which is displayed in the bank or given by its employees to its customers;

(b) material similar to that in clause (a) which is used elsewhere than in the bank but which indicates or implies a connection of the bank with the mutual fund other than that of transfer agent or custodian; and

(c) in the confirmation sent pursuant to paragraph 14.96, recommendation (1) of every purchase of shares or units of the mutual fund effected from or through the bank;

and subsection 157(2) of the Bank Act should be amended accordingly.

Life Insurance Companies

16.30 It is not an exaggeration to state that the introduction of variable insurance policies is the most significant development in the life insurance industry for many years, both in the short-term and in the long-term. In the short-term it is significant as a recognition of the popularity of equity investments for savings dollars, and perhaps also as a development which may increase that popularity if the life insurance companies commence active advertising campaigns for the new policies. In the long-term the introduction of variable insurance policies indicates the willingness of the life insurance industry to compete with other financial institutions by breaking away from its traditional exclusive concentration on fixed-dollar protection, and the same development provides the industry with a technique capable of highly sophisticated use to carry out that competition.

16.31 Variable insurance policies are discussed in paragraphs 1.28 and 1.29, and in more detail in paragraphs 5.37 to 5.46. Briefly, they are life insurance policies which carry guaranteed benefits in the traditional sense but also carry benefits which fluctuate in value with an interest in a segregated fund established by the life insurance company. The mix of guaranteed and variable benefits differs greatly, as do other aspects of the policies; the quotation from the Canadian Life Insurance Association brief in paragraph 5.41 is ample testimony to this. The terms of variable policies can be adjusted in an infinite variety of ways to suit the needs of potential purchasers.

16.32 Regardless of the complications in a particular policy, and in the benefits payable under it, the crucial fact is that every variable policy consists of a combination of fixed and variable benefits. It would be imprecise to state that the benefits under all variable policies could be duplicated through a purchase of conventional, fixed-dollar life insurance together with mutual funds. The combination of fixed and variable benefits may be too complicated for duplication in that way. For example, under many policies the allocation of benefits between the fixed and variable elements may change during the life of the policy. Although the statement therefore lacks precision in the narrow sense, it is meaningful in a wider sense. For the purchaser, the variable insurance policy is not only competitive with a combination of mutual funds and fixed-dollar insurance, but is likely to be considered on the basis that it provides equivalent benefits.

16.33 While the Canadian life insurance industry has been experimenting with this sophisticated new competitive tool, the mutual fund industry has been concerned with its competitive position. Many distribution companies feel that it is no longer enough to sell contractual plans with completion insurance, although such plans provide a good example of the combination of fixed-dollar protection and variable benefits. One distribution company makes available to its customers contractual plans with completion insurance which pays on the death of the planholder an amount that reflects not only the total payments committed under the contractual plan but also an assumed growth rate in the value of the shares or units that would have been purchased had the plan been completed. This type of experiment with the available products is one result of the competitive drive, of which the pressure for dual licensing is another, more important, result. That pressure has come largely or entirely from the mutual fund industry; the implementation of dual licensing will greatly increase its ability to compete with the life insurance industry.

16.34 As the competition between variable insurance policies and mutual funds becomes more aggressive, and the traditional differences between the instruments issued by the two industries decrease in importance, it becomes in-

creasingly difficult to justify differences in the applicable regulations. Yet such differences continue to exist. As a result of historical accident rather than of any logical necessity, the differences relate to the regulation of variable benefits and the sale of the contracts, policies or agreements which provide them. Fixed-dollar insurance benefits, whether sold by mutual fund organizations or life insurance organizations, are clearly subject to the legislation governing life insurance. If legislation governing mutual funds had been the first to evolve, the reverse would probably be true. We do not believe that anomalies in the regulatory structure which result from historical accident and lack logical justification should be retained; this is particularly important when those anomalies provide one financial institution with a competitive advantage over another financial institution.

16.35 Ideally, the regulations which govern a financial institution should allow it to grow, to adapt, and to experiment subject only to any constraints necessary for the protection of the investor. The regulatory scheme proposed in this report is designed to approach this ideal in the regulation of mutual funds. Throughout the report, however, we recognize that the scheme will require adaptation to deal with new financial instruments as they develop. The development of variable insurance policies provides a classic example of the difficulties which arise in an attempt to apply a regulatory scheme designed for one type of instrument, the life insurance policy with fixed-dollar protection, to a new instrument, the variable insurance policy. The applicable legislation has forced the development of variable insurance policies along specific paths; interestingly, these paths differ between Canada and the United States.

16.36 In the United States, virtually the only individual variable policies issued are variable annuity contracts, which are little used in Canada. Variable annuity contracts are, as the name implies, arrangements under which the issuing life insurance company agrees to pay an annuity, for a specified or ascertainable period, with the payments fluctuating in accordance with fluctuations in value of a segregated or separate fund. The contrast between these

contracts and the variable insurance policies sold in Canada is clearly indicated by a review of the quotation in paragraph 5.41; not one of the policies described in that quotation is a variable annuity contract.

16.37 The emphasis on variable annuity contracts in the United States is partially attributable to certain technical restrictions contained in the life insurance legislation of a number of states which inhibit the issuance by life insurance companies of other types of variable policies. The more important reason is that the provisions of the Securities Act of 1933, and probably also of the Investment Company Act of 1940, are applicable to variable insurance policies issued in the United States. The complications involved in the application to variable insurance policies of that legislation, which was prepared before such policies were developed, has been one of the principal factors that have determined life insurance companies in the United States to avoid variable insurance policies and instead to establish relationships with mutual funds. This results in a minor restriction on the flexibility of benefits which can be provided, but the benefits available to purchasers through the combined sale of fixed-dollar life insurance and mutual funds are so similar to those under variable insurance policies that this has not been a material disadvantage. Only the variable annuity contract provides benefits that are not comparable with those available through the combined sale of insurance and mutual funds, so that most variable insurance policies in the United States are variable annuity contracts.

16.38 Developments in Canada have been directed along different paths by applicable regulations in this country. As a result of the prohibition of dual licensing, combined with prohibitions against the acquisition by life insurance companies of subsidiary companies, relationships between life insurance companies and mutual funds similar to those which have been of such importance in the United States have been slow to develop in Canada. In some cases, a single holding company which owns a life insurance company also owns a mutual fund management and distribution company. Several mutual fund management companies own life insurance companies; two of these are United Funds Management Limited and The Investors Group, discussed in paragraphs 1.12 to

1.17. Speaking generally, however, the availability of these alternatives has been of little assistance to Canadian life insurance companies and they have been forced by the restrictions to concentrate their attentions on variable policies rather than on the development of relationships with mutual funds.

16.39 We venture no opinion on the relative merits of variable insurance policies and the combined sale of fixed-dollar life insurance and mutual funds. Neither alternative is inconsistent with adequate protection of the investor, and it is therefore not our responsibility to formulate such an opinion. The decision should be made on the basis of competitive experience in a free market. The regulatory scheme should therefore be shaped to allow for experiments with each type of vehicle. Developments to allow such flexibility have occurred in the few months preceding the time of writing. Dual licensing has been permitted on a restricted basis,and amendments have been proposed to the federal legislation governing life insurance companies which would permit the extension of relationships between life insurance companies and mutual funds.*

16.40 While we support the developments referred to in the preceding paragraph, and feel that amendments similar to those quoted in the footnote to that paragraph should be made to provincial insurance legislation, we think these developments should be regarded as only temporary measures. What is really needed is a more complete revision of the applicable legislation in order to provide a regulatory environment within which the competition between the mutual fund and life insurance industries can grow and develop in the public interest free of artificial constraints or competitive advantages for either

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* Section 20 of Bill-35 (supra, footnote to paragraph 9.20) would repeal section 64A of the Canadian and British Insurance Companies Act and replace it with a new section 64A which would permit the acquisition by a life insurance company of:

> ... (e) any corporation incorporated to offer public participation in an investment portfolio,
>
> (f) any corporation incorporated to provide a corporation mentioned in paragraph (e) with advisory, management or sales distribution services,
>
> ...

industry. In our opinion, the proposals in this report provide a reasonable and workable scheme for the control of mutual funds. A similar scheme should be applied to variable insurance policies, not only to provide a regulatory environment of the type we envisage but also because almost every proposal we make is designed to resolve a problem which is, or can be, present in the operation of variable insurance policies and the segregated funds upon which they are based.

16.41 We recognize that the regulatory scheme proposed in this report cannot be effectively applied to variable insurance policies unless modifications are first made in that scheme. This is acknowledged by our conclusion in Chapter V that segregated funds are not mutual funds within our proposed definition of the term. Any attempt to apply regulations designed for mutual funds, without modification, to segregated funds would produce problems similar to those which have arisen in the United States and are alluded to in paragraph 16.37, although the differences between our proposals and the requirements of the 1933 and 1940 Acts would considerably reduce the scope of such problems. We have concluded that the formulation of the necessary modifications should be done in the context of life insurance legislation generally, and ought therefore to be carried out under the aegis of the Superintendents of Insurance, federal and provincial. They are the only governmental group with the necessary qualifications and experience to perform that task. We commend it to them as a matter of great importance.

16.42 One step should, we have concluded, be taken immediately. Perhaps the single most important difference between the regulatory scheme applicable to mutual funds and that applicable to life insurance companies is in the area of disclosure. Historically, the difference is understandable; the emphasis in the regulation of life insurance has traditionally been on reserve requirements. That factor is not relevant to the variable element in variable insurance policies, and we believe that the purchaser of a variable insurance policy is entitled to disclosure at least as complete as that provided for the purchaser of the share or unit of a mutual fund. Even more extensive disclosure may be necessary with variable policies, because the disclosure document should

include an explanation of the terms of the variable policy and of the relationship between the fixed and variable benefits it contains. Requirements should be instituted as soon as feasible to provide adequate disclosure for purchasers of individual variable policies.

16.43 Preliminary steps towards more detailed disclosure have been taken by the provincial Superintendents of Insurance through interim requirements applicable to the sale of individual variable policies. Those requirements have been partially shaped by the belief of the Superintendents of Insurance that the full prospectus requirement would be inappropriate, as a result of which the requirements are less extensive than those applicable to mutual funds. The reasons for this belief are, we think, adequately reflected by the proposals in Chapter XIV for the use of a summary prospectus as well as a full prospectus. Those proposals and the reasons for the use of the two types of prospectus are as relevant to variable insurance policies as they are to mutual funds. The disclosure requirements applicable to individual variable policies should parallel the proposals in Chapter XIV, in the use of summary prospectuses, full prospectuses, and prospectus delivery requirements. They should also include similar restrictions on sales literature and advertising.

16.44 Our conclusion that disclosure requirements should be instituted as soon as feasible relates specifically to individual variable policies. In its brief to us, the Canadian Life Insurance Association commented with respect to group variable policies that "the policyholder ... is usually an employer or association with access to independent accounting and legal advice".* Where that is true, the protection of prospectus requirements is not of the same importance that it is in other cases. Not only are the purchasers persons for whom the product purchased is a shopping good, they are sufficiently knowledgeable to be able to demand the necessary information and therefore to dispense with the full prospectus. The difficulty is that not all group variable policies, using the term "group", as it is defined for other purposes in the regulation of life insurance companies, are negotiated in the circumstances described in the quotation. We have concluded that for disclosure purposes

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* Supra, footnote to paragraph 14.27, page 25.

those policies which are not negotiated in such circumstances should be treated as individual variable policies, and disclosure should be made to each member of the group insured under the policy.

16.45 The conclusion set out in the preceding paragraph was easy to reach in principle, but we found it more difficult to determine which group variable policies should be treated as individual variable policies on the assumption that they may not be negotiated on the basis described in the quotation. In our deliberations on this point we have benefited from the views of the Canadian Life Insurance Association and others. We have concluded that for disclosure purposes, all variable insurance policies should be considered to be individual variable policies except those group policies which fall within one or more of three categories. We stress that these proposals are not intended to be relevant to the definition of "group" as used in other contexts.

16.46 An obvious example of a group policy is one issued to an employer to insure his employees. In many or most cases, the employer retains professional advice and negotiates the policy in detail with the life insurance company. When this occurs it is reasonable to rely on the employer and not to require that the employees be provided with prospectuses and similar disclosure documents. On the other hand, cases arise in which the employer looks on the group policy only as a convenience for his employees and directs little effort to its negotiation. In such cases the employees who are insured and contribute under the policy should be provided with the benefits of the disclosure requirements. We have concluded that the only employer group policies which can be assumed not to fall within the latter category are those under which the employer himself assumes a direct or contingent responsibility to pay money, other than by way of guarantee of an employee's primary obligation. Employer group policies which satisfy that condition form the first of the three categories policies which we propose for exemption from the prospectus requirements, although exemptions might be obtained for other employer group policies under the proposal in paragraph 16.48.

16.47 A second major category of group policies are those in which the policyholder is a trade union. The same problem arises here as with employer group policies: some are, and some are not, carefully negotiated.

Again, we have concluded that it is only possible to define one group where careful negotiation may be assumed to occur and that other group policies of this type must be treated as individual policies unless they can be brought within the third category. The group consists of those union policies which are issued to the union in order to carry out provisions contained in a collective bargaining agreement. The circumstances of these agreements are such that their careful negotiation can be assumed. Such policies therefore form the second of the three categories.

16.48 There are other circumstances than those described above in which group policies are issued. One important example is policies issued to associations. We have considered this and other types, but have been unable to identify any other general category of group policies which would always be negotiated in circumstances such that disclosure protection was unnecessary. There may, however, be many group policies that are negotiated on that basis although they fit within neither of the two categories outlined above. We have therefore concluded that the administrator should have authority to exempt a group variable policy sold to any named person or organization from the application of the prospectus and related requirements. The administrator would grant the exemption on being satisfied that negotiations were being conducted on a basis such that the protection afforded by those requirements was unnecessary. Policies sold under such an exemption constitute the third of the three categories we propose.

16.49 The procedure we envisage for a ruling that compliance with the prospectus requirements is not necessary for a variable policy sold to a named group or organization would be substantially similar to that under which the administrators of several provincial securities acts are able to recognize an organization as an exempt purchaser, so that the ordinary prospectus requirements do not apply on a sale to that organization. The administrator should have authority to make his order subject to compliance with such conditions as he thinks fit. An exemption should be included in the requirements for delivery of a summary prospectus to permit preliminary negotiations in cases where

an application for exemption is proposed, provided that the application is made with reasonable promptness. If the exemption is refused the proposed policy would be considered to be an individual variable policy and the negotiations would cease unless and until a summary prospectus was delivered to the potential purchaser.

16.50 The proposals made in this section contemplate the development both of variable policies and of the combined sale of fixed-dollar insurance and mutual funds. In paragraph 16.42 we note the importance of disclosure concerning the terms of variable insurance policies, particularly the relationship between the variable and fixed benefits they provide. Similar disclosure is of equal importance in cases where a combination of fixed-dollar life insurance and mutual funds is sold, except for the simplest cases involving an ordinary insurance policy and a direct investment in mutual funds. The scheme arrived at under the aegis of the Superintendents of Insurance should provide for adequate disclosure in cases where the two are combined in more complicated ways. An example would be the equity funding contracts developed in the United States, under which the accretion in value of a mutual fund investment is relied upon to contribute to the cost of life insurance.

16.51 For the reasons set out in this section, we recommend:

(1) that provincial statutes governing life insurance companies should be amended by the addition of provisions similar to those referred to in the footnote to paragraph 16.39, so that life insurance companies may establish associations with mutual funds;

(2) that the provincial and federal Superintendents of Insurance should arrange for the preparation under their aegis of modifications in the regulatory scheme proposed in this report to permit the effective application of that scheme to variable insurance policies and the segregated funds upon which they are based; this should be done as quickly as possible, and the scheme as modified should be applied to such policies and funds as soon as possible after completion of the modifications;

(3) that the requirements in Chapter XIV concerning prospectuses and summary prospectuses and their delivery, and concerning the content of sales literature, should be modified immediately for application to individual variable policies; the requirements arrived at should result in disclosure as extensive as is required for mutual funds, and should include information concerning the terms of policies and the relationship between their fixed and variable benefits;

(4) for purposes of recommendation (3), the term "individual variable policy" should include any life insurance policy under which the benefits are determined in whole or in part by the value of an interest in a segregated fund, except for any such policy that:

(a) is a group policy as that term is defined for other purposes in life insurance regulation; and

(b) which satisfies any of the following requirements:

(i) the policyholder is an employer whose employees are insured under the policy and who is himself subject to a direct or contingent responsibility to pay money under the policy, other than under a guarantee of an employee's primary obligation;

(ii) the policyholder is a union and the policy is issued to carry out provisions in a collective bargaining agreement; or

(iii) on application by either the life insurance company or the proposed purchaser, the administrator recognizes the purchaser of the policy as one which does not need the protection of the disclosure rules applicable to individual variable policies; the administrator should have authority to make his recognition subject to compliance with such conditions as he thinks fit;

(5) that the disclosure requirements applicable to individual variable policies should permit negotiations to be commenced for the issuance of a policy without the delivery of a summary prospectus if an appli-

cation to the administrator for exemption under sub-clause (iii) of clause (b) recommendation (4) is intended, provided that the application is made promptly and that the negotiations are ended or a summary prospectus delivered if the application is unsuccessful; and

(6) that the modifications referred to in recommendation (2) should provide for disclosure of the terms of contracts for the sale of life insurance and mutual funds in combination except where the sale is merely a sale of a conventional life insurance policy together with mutual fund shares or units.

Trust Companies

16.52 The problems involved in the application of the regulatory scheme proposed in this report to trust company investment funds are far less difficult than those involved in its application to individual variable policies and the segregated funds upon which they are based. The latter are so closely related to other aspects of the operations of life insurance companies that the application to them of the regulatory scheme is not feasible unless it is modified for the purpose, as proposed in the preceding section. Modifications also seem appropriate for trust company investment funds, but only to carry out the principle expressed in paragraph 16.02 that, to the extent that other regulations applicable to a financial institution accomplish the objectives of recommendations made in this report, it would be pointless to duplicate those regulations through application of the requirements we propose. These considerations fortify us in the conclusion expressed in Chapter V that trust company investment funds do, while segregated funds of life insurance companies do not, satisfy our proposed definition of a mutual fund.

16.53 One important exemption will be available to almost every trust company. In paragraph 14.15 we suggest that the administrators should exercise their discretionary exemptive powers so that the registration and training requirements will not apply to salesmen associated with sales organizations which have no salesmen "on the road" and which levy no sales charges.

While such an exemption should not be granted to a trust company that uses other techniques to appeal to purchasers for whom mutual funds are unsought goods, even if it satisfies the two specific conditions, we anticipate that most trust companies will qualify for the exemption. The conclusions expressed in paragraphs 16.25 to 16.27 concerning the registration and training of bank employees should be applicable, with necessary changes, to any trust companies which are denied the exemption. Of course, the availability or otherwise of the exemption from registration and training requirements will not affect the application of the prospectus and other disclosure requirements.

16.54 For two reasons, we have been unable to reach precise conclusions concerning what, if any, other exemptions are appropriate for trust company investment funds. The first reason is that many of the rules presently applied to trust companies in aspects of their operations which involve problems similar to those dealt with in this report are formulated on a discretionary basis by the administrators concerned. They vary from province to province, and sometimes from case to case. This makes it impossible for us to reach conclusions concerning what problems are adequately dealt with by the existing regulations. Any exemptions from the mutual fund regulatory scheme which are granted to trust companies should be based on a clear determination of the adequacy of the existing rules.

16.55 The second reason for our inability to reach precise conclusions on exemptions for trust company investment funds arises from the practical consideration that the decision must be influenced by the arrangements made for the administration of the mutual fund legislation as it applies to trust company investment funds. If the administration is to be the responsibility of the same agency which administers other legislation applicable to trust companies, the problems of overlapping requirements will be less than if separate administrators are involved. In the latter case, the necessary exemptions would probably be wider than in the former. We discuss the question of administrative responsibility in paragraphs 19.10 to 19.14 and reach no conclusion,

although we express sympathy with the reluctance of the trust companies to be subjected to different administrative authorities. We are therefore not able to make any assumption concerning the influence the administrative structure may have on the practical need for exemptions.

16.56 While for these two reasons we make no specific proposals concerning the exemptions from our proposed regulatory scheme which should be granted to trust companies, one suggestion seems appropriate. Our studies indicate that the quality of control applied by supervisory authorities to the custody by trust companies of their assets is sufficient to provide protection as effective as that which would be available through the application of the requirements outlined in Chapter VIII. Should the findings of the appropriate administrators confirm this opinion, it would be desirable to grant an exemption for trust company investment funds from the requirements as to custody of assets proposed in Chapter VIII, and to permit trust companies to act as custodians of their investment funds even though they are also management companies of those funds.

16.57 For the reasons set out in this section, we recommend:

(1) that in cases where the appropriate administrator finds that the protection provided to the investor under regulations applicable to trust companies generally and hence to trust company investment funds is at least as effective as that which would be provided by the application of corresponding regulations proposed in this report, he should exercise his exemptive power granted pursuant to paragraph 7.20, recommendation (6) to exempt the trust company investment funds concerned from application of the latter requirements;

(2) that in any case where the employees of a trust company are not exempted from registration pursuant to paragraph 14.25, recommendation (1), the recommendations in paragraph 16.51 concerning bank employees should be applicable, with necessary changes;

and we suggest

(3) that an exemption of the type contemplated by recommendation (1) would

ordinarily be appropriate with respect to the requirements for custody of assets proposed in Chapter VIII, and to permit a trust company to act as custodian of an investment fund offered by it for public participation.

Foreign Mutual Funds

16.58 As international financial markets become increasingly connected and investors become increasingly interested in and aware of foreign investment possibilities, it is reasonable to anticipate that foreign mutual funds will correspondingly increase the extent of their sales to Canadians. This presents a difficult question from a regulatory standpoint, for conflicting objectives arise in the formulation of regulations applicable to foreign mutual funds. If the sole relevant objective was the protection of the Canadian investor, the important consideration would be that it is inconsistent and illogical to apply to Canadian-organized mutual funds a regulatory scheme such as we propose in this report while permitting the Canadian distribution of foreign mutual funds which are not subject to such a scheme. This would produce a rigorous approach to regulation of foreign mutual funds.

16.59 Other considerations can be advanced in support of a more liberal approach to foreign mutual funds than that indicated in the preceding paragraph. We are reluctant to propose requirements which would have an impact on national economic policy, yet a very rigorous approach to the regulation of foreign mutual funds might have such an impact. Implementation of such proposals could dissuade foreign mutual funds from entering Canada, and might also provoke retaliatory measures against Canadian mutual funds in other countries.

16.60 The problems to be resolved in the regulation of foreign mutual funds are to some extent simplified by the fact that, at December 31, 1968, every foreign mutual fund qualified for sale in Canada was a United States mutual fund; to the time of writing, we are not aware of any change in that position, although at least one mutual fund from another country had applied for qualification to sell in several provinces. We include as United States mutual funds a number of mutual funds organized in other countries as a result

of tax considerations but which invest exclusively in the shares of a single United States mutual fund. We collected statistical information from the 12 United States mutual funds qualified for sale in Canada at December 31, 1967 (by the end of 1968, the number had increased to 19); their total sales to Canadians during 1967 exceeded $60 million, and redemptions were approximately $7 million, for an estimated net of $53 million. Limited information available to us indicates that sales to Canadians increased during 1968.

16.61 In addition to the sales by United States mutual funds qualified for sale in Canada, we believe that a substantial volume of sales to Canadians is made by mutual funds not qualified for sale in this country. The Investment Company Institute in the United States annually publishes statistics as to the volume of sales made by its member mutual funds to Canadians; for 1967, net sales were $57 million.* Even that figure is almost certainly incomplete, not only because the I.C.I. does not represent all the United States mutual funds but because in many cases a distribution company would be unaware that the purchaser was a Canadian. Sales to Canadians by mutual funds not qualified in Canada are facilitated by the regular publication in the Canadian financial press of price quotations for United States mutual funds. We comment in paragraphs 7.11 to 7.16 on the purchase by Canadians of shares or units issued by foreign mutual funds not qualified for sale in Canada, and make proposals to avoid abuses. We conclude in Chapter VII that the registration requirement should extend to any foreign mutual fund (with limited exceptions) the shares or units of which have been or are being offered to the public in Canada.

16.62 The conclusions in Chapter VII do not assist in the resolution of the principal question at issue here, the extent to which a registered foreign mutual fund should be required to comply with Canadian legislation governing the mutual fund industry. We are clearly of the opinion that all requirements concerning the distribution of shares or units to the public, including disclosure rules and rescission rights, should be applicable to foreign mutual funds as to Canadian mutual funds. The difficulties arise with those requirements which affect the internal operation of mutual funds; the most im-

* Mutual Fund Fact Book, Investment Company Institute (New York, 1968), page 45.

portant, but not the only, proposals we make for requirements of this type are those in Chapter VIII concerning custody of assets, in Chapter IX concerning conflicts of interest and in Chapter XII concerning restrictions on investment activities.

16.63 It is of interest to note the approach adopted by the Securities and Exchange Commission in the United States to the regulation of Canadian mutual funds the shares or units of which are sold in that country. Rule 7d-1 under the Investment Company Act of 1940 contains a number of technical adjustments of the provisions in that Act for application to Canadian mutual funds. Experience has indicated, even if it were not clear from the rule itself, that the adjustments do not make it feasible for the shares or units of a Canadian mutual fund to be sold in the United States if they are also being sold in Canada. The rule has only been used by one important group of mutual funds. For a period ending in 1962, non-resident owned funds enjoyed popularity both because of income tax considerations which were changed in that year, and because of interest in the Canadian market by residents of the United States. While such mutual funds were organized in Canada, they were distributed exclusively to residents of the United States; they therefore found it feasible to comply with the 1940 Act as modified by Rule 7d-1, including requirements that assets be kept in the United States and that a majority of their directors be residents of the United States.

16.64 We are aware of only one instance in which a Canadian-organized mutual fund has successfully complied with the 1940 Act and simultaneously been qualified for sale in Canada. In that instance, the mutual fund was organized by a United States organization, and invests almost entirely in that country; it is, in fact, operated as a United States mutual fund except that it was organized and is qualified for sale in Canada. We regard it as an exception which proves the rule, and which is not inconsistent with our conclusion that Rule 7d-1 is not adequate to make it feasible for shares or units of a Canadian-organized mutual fund to be sold simultaneously in the two countries.

16.65 The considerations which motivated the Securities and Exchange Commission in its approach to Rule 7d-1 are readily understandable; similar considerations have weighed heavily with us in the conclusions set out in this section. They arise from the reasoning described in paragraph 16.58; if a regulatory scheme is thought necessary for the protection of the investor, mutual funds should not be excluded from it merely because they are organized in a foreign country. We recognize the validity of this reasoning, and that it must be accepted if the regulatory scheme is to be effective. On the other hand, the considerations set out in paragraph 16.59 persuade us that foreign mutual funds registered in Canada should not be invariably and rigidly forced to comply with all aspects of the Canadian regulatory scheme; provision should be allowed for exceptions, and the most valid reason for an exception would be the availability of equivalent requirements under the laws of another jurisdiction. If a mutual fund is subject to requirements under the laws of another country which effectively accomplish the objectives of corresponding provisions of Canadian law, it would be consistent with protection of the Canadian investor to grant that mutual fund an exemption from the relevant Canadian requirements. Subject to one additional consideration, set out below, it would be appropriate to grant such an exemption.

16.66 Our conclusions concerning exemptions for foreign mutual funds are substantially similar to the conclusions set out in the preceding section concerning exemptions for Canadian trust companies. In each case, the most important question will be whether the regulations to which the organization is subject are adequate to attain the objectives described in this report. In each case, that decision should be made by the administrator through the exercise of his exemptive powers. The regulatory scheme should, therefore, apply to all foreign mutual funds required to register in Canada. Exemptions would be granted by the administrator, where appropriate, through the use of the power proposed in paragraph 7.19. Subject to the additional consideration described in the following paragraph, this exemptive power should be liberally exercised in any case where its exercise would be consistent with the protection of the Canadian investor.

16.67 The additional consideration which should be taken into account by the administrator in his decisions concerning exemptions is that there is no reason why Canada should grant exemptions to mutual funds organized in a foreign country so that they may operate within Canada, unless similar exemptions are provided by the foreign country for Canadian mutual funds. Such an approach would not result in the denial of access by Canadian investors to adequately regulated foreign mutual funds, since they would be permitted to purchase under the proposal in paragraph 7.15. It would only result in the denial of the right to engage in selling activities for the foreign mutual fund in Canada.

16.68 The conclusion set out in the preceding paragraph requires particular consideration as it affects United States mutual funds. In paragraph 8.09 we propose an exemption from the requirement that the assets of registered mutual funds be maintained in custody in Canada, for mutual funds subject to the Investment Company Act of 1940 and qualified for sale in Canada when the legislation becomes effective. A similar exemption would be appropriate from other provisions of the regulatory scheme which would otherwise prevent United States funds qualified in Canada from continuing to sell in this country after the legislation becomes effective. These exemptions should be limited to an interim period during which negotiations would be conducted between Canadian authorities and the Securities and Exchange Commission to arrange reciprocal exemptions which would effectively permit mutual funds from each country to be distributed in the other country. We have been informally advised by representatives of the S.E.C. that they would be receptive to such discussions following the adoption of an adequate regulatory scheme for mutual funds in Canada.

16.69 It might be said that negotiations such as those proposed in the preceding paragraph would be pointless in view of the Interest Equalization Tax in the United States, which would almost certainly prevent residents of that country from purchasing shares or units of Canadian mutual funds. We would quarrel with such a statement. The Interest Equalization Tax and similar measures are the product of national economic policy, and are subject to rapid adjustment as that policy changes. Requirements established for the protection

of the investor should not be made unnecessarily rigid simply because such measures as the Interest Equalization Tax would prevent the regulated institutions from taking advantage of more flexible provisions; rather, they should be so designed as to enable maximum advantage to be taken of adjustments in those measures. That will, we hope, be the result of the proposed negotiations with the S.E.C.

16.70 For the reasons set out in this section, we recommend:

(1) that the administrator should be prepared to exercise his discretionary authority pursuant to paragraph 7.20, recommendation (6) in order to grant exemptions from portions of the regulatory scheme for foreign mutual funds which are subject to equally effective requirements under the laws of another jurisdiction; such exemptions could operate in favour of all mutual funds subject to the laws of a jurisdiction, or in favour of a particular mutual fund;

(2) that exemptions of the type contemplated by recommendation (1) should be liberally granted to the extent consistent with adequate protection for the Canadian investor, but should not be granted to a foreign mutual fund unless corresponding exemptions are available to Canadian mutual funds in its country of organization; nor should exemptions be granted from the requirements proposed in this report as to sales practices and techniques;

(3) that, pending the negotiations proposed in recommendation (4) exemptions should be granted to mutual funds which are subject to the Investment Company Act of 1940, and are operating within the relevant Canadian jurisdiction at the effective date of the legislation, as defined in paragraph 7.20, recommendation (1); such exemptions should be reconsidered if the negotiations are not effective; and

(4) that negotiations should be conducted with the Securities and Exchange Commission with a view to the formulation of reciprocal exemptions which will make it feasible for a mutual fund organized in Canada or in the United States to be distributed in both countries.

CHAPTER XVII

INVESTMENT CONTRACTS

17.01 Investment contracts differ fundamentally from shares or units of mutual funds because the amount of money to which the investor is entitled is established by the contract instead of being determined by reference to the value of a proportionate interest in a portfolio of investments. The investment contract is, then, a debt instrument rather than an equity instrument. The contract specifies the amount payable by the issuing company on the maturity date of the contract, and ordinarily also includes optional settlements which the purchaser may select instead of a cash payment. In addition, the rights of the holder to receive a cash surrender value or other benefits if he terminates prior to maturity of the contract are set out. In most cases, the company also indicates that it may credit the contract annually with additional amounts, referred to as "additional credits" to increase its maturity and cash surrender values. As this summary indicates, the arrangements embodied in an investment contract are simple in outline; the complexities arise in their details.

17.02 As with mutual funds, it is difficult to define with precision the features that distinguish investment contracts from similar instruments issued by other financial institutions. Debt instruments which promise the holder a fixed rate of return are the traditional vehicles offered by financial institutions to attract savings dollars. Banks, credit unions and trust companies are only three of the financial institutions which issue such instruments. In all these cases the institutions act as financial intermediaries, investing the money they receive from the public in other types of investments

such as mortgages and government and corporate bonds. Their profit is derived from the excess of the amount earned on such other investments over what is required to provide the promised return under the debt instruments sold to the public, and expenses. For that reason, it is usually not possible for them to promise as high a rate of return as that which is available under mortgages or bonds of corresponding maturities.

17.03 Financial institutions which offer debt instruments use a variety of techniques to make their instruments more appealing to various classes of purchasers than mortgages or bonds, in spite of the lower promised rates of return. The principal technique is the adaptation of the instruments to the specific needs of classes of investors; through such adaptation the institution concerned plays the classic role of the financial intermediary which purchases one type of investment and issues another. This appeal is supplemented by services designed to cater to the investor, and by emphasis on financial stability and security. The benefits provided by these two techniques are usually brought to the attention of the public by distribution facilities superior to those ordinarily available to issuers of mortgages and bonds. All of these statements are particularly true of the investment contract industry, yet they do not serve to distinguish it from other types of financial institutions.

17.04 It is in the application of the techniques described in the preceding paragraph that the distinguishing features of investment contracts are to be found. The first such feature is the use of optional settlements. These exemplify the adaptation of the contracts to the needs of a class of investors, namely those who may wish to apply the money at maturity to another long-term investment. The most important type of optional settlement is an annuity, a fact which emphasizes the appeal made by investment contracts to savings dollars. The second feature exemplifies both the adaptation of the contracts to the needs of a class of investors, and the endeavour to make a direct appeal to the public. Many (but far from all) investment contracts are sold on an instalment payment basis, with monthly payments in dollar amounts of from $4.00 to, rarely, $40.00 or more. In an extensive sampling of such instalment investment contracts, we found that 62% of them called for monthly payments of $15.00 or

less, and 80% of them called for monthly payments of $25.00 or less. These figures show clearly that the class of investors for which these contracts are tailored includes persons in a comparatively low income bracket who wish to save by putting a small amount of money aside each month. Such contracts also indicate the scope of the services offered by investment contract companies, since a considerable administrative burden is involved in the processing of small cheques on a monthly basis.

17.05 In Chapter II and elsewhere in this report we comment on the nature of the competitive situation in the distribution to the public of mutual fund shares or units. Our conclusion is that the market for shares or units is divided between purchasers for whom they are unsought goods and those for whom they are shopping goods, and that in the former segment of the market the competitive structure is anomalous because competition focusses on the drive to provide the salesman with maximum compensation rather than on the drive to reduce the price to the purchaser. This conclusion is at least equally applicable to investment contracts. The importance of instalment investment contracts is in our opinion attributable to the anomalous nature of the competitive structure. In paragraphs 2.23 to 2.26 we describe contractual plans for the purchase of shares or units; there and in paragraphs 10.97 to 10.104 we discuss various possible explanations of why these plans are purchased in spite of the fact that they contain certain inherent disadvantages for the investor. The conclusion in paragraph 10.104 that experience under contractual plans "is unsatisfactory on the average and that a purchaser who compared the available alternatives would probably not select this method of investment" is also true of instalment investment contracts. The principal appeal of both arrangements is to purchasers for whom these investments are unsought goods, and the pricing structure of each is geared to provide the salesman with maximum compensation as early as possible in the life of the contract.

17.06 The similarity of competitive structures was one of the principal reasons for the inclusion of investment contracts together with mutual funds in the scope of responsibility of this Committee. The other principal reason was the similarity in distribution techniques used. Mutual fund distri-

bution companies in Canada rely largely, and investment contract companies almost entirely, on direct sales forces to effect public sales of their respective products. In addition, every investment contract company has a relationship with a mutual fund or distribution company so that all salesmen who sell investment contracts are also able to provide their customers with shares or units of mutual funds, although not all mutual fund salesmen have investment contracts available for sale. Another consideration was that in the United States investment contracts, which are referred to in that country as "face amount certificates" are subject to the Investment Company Act of 1940 as are mutual funds. Because these features resulted in the inclusion of investment contracts in our work, they and their implications receive considerable attention in the following discussion, but the discussion is not confined to them. Our responsibility extended to a wider analysis of the industry's operations and the applicable regulations.

17.07 A theme constantly stressed by representatives of Canadian investment contract companies, with whom we have had many discussions, is that investment contracts should not be considered apart from life insurance. Their contention is that life insurance companies are their most direct competitors both in the nature of the product offered and in the method of distribution used. As to the nature of the product offered, it is said that investment contracts provide benefits almost identical to the savings element of a life insurance policy other than a term policy; and that an instalment investment contract sold with decreasing term life insurance (and approximately 25% of instalment investment contracts are so sold) provides benefits almost exactly identical to those under an endowment life insurance policy. As to the method of distribution used, the extensive reliance on direct sales forces which characterizes the distribution of investment contracts is also true of life insurance policies.

17.08 We allude frequently in the following discussion to the comparison with life insurance. We recognize the relevance of that comparison by concluding that regulations similar to those applicable to life insurance companies ought to be more extensively applied to investment contract companies.

However, we reject the contention of the investment contract industry that no regulations should be applied to it unless corresponding regulations are applied to life insurance companies. It is apparent to us that the principal interest of the life insurance purchaser is in the protection received under his policy, while the principal interest of the investment contract purchaser is in savings. In addition, our responsibility is to conduct a study of the investment contract industry and it would be inconsistent with that responsibility for us to fail to make proposals for regulations we think desirable simply because the life insurance industry is not subject to similar regulations. Such arguments may be more relevant for legislative consideration prior to the implementation of our proposals, although we intend no implication that any specific proposal we make is also appropriate for application to life insurance companies. A separate study of that industry would be necessary before any decision was made concerning the application to it of the proposals we make for the regulation of investment contract companies.

17.09 In the following sections we first briefly describe the investment contract industry as it is in Canada at the time of writing. Subsequent sections discuss the meaning of the term "investment contract", the regulations presently applicable to investment contracts, and the provisions of such contracts. The chapter concludes with a summary of the results of a study we conducted of experience under instalment investment contracts.

The Investment Contract Industry

17.10 Apart from one or two companies which formerly issued investment contracts and continue to have some outstanding, the Canadian investment contract industry at the time of writing is made up of eight companies, belonging to six organizations. Two of the organizations include two associated companies. One company, Commonwealth Savings Plan Ltd., is at the time of writing in serious financial difficulties. It is mentioned in the preface to this report, where we also comment on our inability to obtain statistical information from the Commonwealth group of companies. The statistical information concerning investment contract companies which is presented in this and the following chapter should be taken to exclude Commonwealth Savings Plan Ltd.

17.11 Two associated investment contract companies, First Investors Ltd. and Associated Investors Ltd., have their headquarters in Edmonton; they form part of a financial complex known as the Principal Group. Two other associated companies, Investors Syndicate Limited and The Western Savings and Loan Association, have headquarters in Winnipeg; they form part of the Investors Group complex, described in paragraphs 1.12 to 1.16. Savings and Investment Corporation has headquarters in Quebec City, and Keltic Savings Corporation Limited and Service Investments Corporation Limited in Halifax. By far the largest of these companies is Investors Syndicate Limited. Its predecessor, Investors Syndicate of Canada, Limited was the first major investment contract company in Canada, and the methods of operation of most of the other Canadian companies have directly or indirectly been patterned on those of the Investors companies.

17.12 Total liabilities for outstanding investment contracts of the seven companies being considered, at the end of their 1967 fiscal years were about $410 million. Of this, some 82% was attributable to outstanding contracts of Investors Syndicate Limited and its associated company, The Western Savings and Loan Association. Approximately 67% of industry liabilities were attributable to contracts sold on an instalment basis, and the remaining 33% to contracts sold on a single payment basis. The principal type of investment made by the investment contract companies with money raised by them from the public is in mortgages. At the end of their 1967 fiscal years, Canadian investment contract companies held some $320 million in mortgages.

17.13 As noted in paragraph 17.06, every investment contract salesman is also able to provide his customers with mutual funds. Our observations indicate that in recent years the mutual fund aspect of their business has increased in comparative importance. Some confirmation of this is derived from the limited statistical information available to us. We collected information concerning the percentage of the 1967 income of salesmen for Investors Syndicate, Limited derived from investment contract sales. Although that company only developed an association with mutual funds in 1950, by 1967 more than two-thirds of its salesmen derived over one-half of their income from mutual

fund sales. The declining comparative importance of investment contracts is further confirmed by the fact that the contract liabilities of the industry as a whole grew only from about $320 million at the end of 1962 to about $410 million at the end of 1967.

17.14 The declining comparative importance of investment contracts is presumably at least in part attributable to the great success of the mutual funds industry and the increasing popularity of equity investments during the period from 1962 to 1967. In this as in other endeavours, success is its own reward; the popularity of mutual funds as an investment vehicle doubtless leads salesmen to accord greater stress to them than to investment contracts. We believe, however, that an increasing proportion of investors who wish fixed-interest returns are purchasing instruments issued by other financial institutions which can frequently provide a higher rate of return because they need not compensate salesmen. This belief is based both on observation and on many comments made to us by industry representatives. To the extent that it is true, it reflects an increasing degree of knowledge and awareness on the part of investors who are able and willing to seek out alternatives to the investments offered by salesmen.

17.15 While the investment contract industry is not in a period of rapid growth, it is a significant factor in the economy, and its importance from the viewpoint of investor protection is accentuated by the fact that it receives its money from large numbers of low-income investors. The fact that for many or most of these investors the contracts were purchased as unsought goods further confirms the importance of a careful assessment of the industry to verify that it is being carried on in the public interest.

Definitions of an Investment Contract

17.16 The definitions of "investment contract" used in the applicable legislation in Alberta, British Columbia, Ontario, Newfoundland and Saskatchewan are comparatively uniform. That in The Investment Contracts Act (Ontario)* reads as follows:

* R.S.O. 1960, c. 194, Corresponding statutes in other provinces are: Alberta, 1957, c. 36, amended in 1960, c. 51; 1962, c. 37; 1963, c. 27; and 1966, c.43. British Columbia, 1962, c. 30; Newfoundland, 1961, c. 14; Saskatchewan, R.S.S. 1965, c. 144.

1(b) "investment contract" means a contract, agreement, certificate, instrument or writing containing an undertaking by an issuer to pay the holder thereof, or his assignee, or personal representative, or other person, a stated or determinable maturity value in cash or its equivalent on a fixed or determinable date and containing optional settlement, cash surrender or loan values prior to or after maturity, the consideration for which consists of payments made or to be made to the issuer in instalments or periodically, or of a single sum, according to a plan fixed by the contract, whether or not the holder is or may be entitled to share in the profits or earnings of, or to receive additional credits or sums from, the issuer, but does not include a contract within the meaning of The Insurance Act.

17.17 We consider this an unsatisfactory definition and we propose that it should be revised. Both to describe investment contracts and to explain our criticisms of the definition, it is helpful to set out the requirements specified in the definition which must be satisfied if a financial instrument is to be regarded as an investment contract. The instrument must:

(i) be a contract, agreement, certificate, instrument or writing;

(ii) contain an undertaking by the issuer to pay the holder, or his assignee, or personal representative, or other person, a stated or determinable maturity value in cash or its equivalent on a fixed or determinable date;

(iii) contain optional settlement, cash surrender or loan values prior to or after maturity;

(iv) be paid for by a consideration which consists of payments made or to be made to the issuer in instalments or periodically, or of a single sum, according to a plan fixed by the contract; and

(v) not be a contract within the meaning of The Insurance Act.

A document which satisfies these five requirements is an investment contract regardless of whether it entitles the holder to participate in profits or earnings of the issuer.

17.18 In paragraph 17.04 we note that the two distinguishing features of investment contracts are, in our opinion, that they provide optional settlements and that a large proportion of them are sold on an instalment payment basis. In view of that statement, it is of interest that requirements (i),

(ii), (v) and most of requirement (iv) listed in the preceding paragraphs are satisfied by almost every financial instrument which carries a fixed rate of return. The only parts of the definition not almost invariably satisfied by other financial instruments are that an investment contract must contain optional settlement, cash surrender or loan values, and that payment for it must be made according to a plan fixed by the contract. The latter is, however, true of many financial instruments other than investment contracts. As to the former, while it is one of the distinctive features of investment contracts we have concluded that it is not a feature upon which reliance should be placed for purposes of definition. For example, if an investment contract company issued an instrument under which a purchaser made a single payment in exchange for the right to receive a larger amount at maturity, but with no optional settlement, cash surrender or loan privileges, and no plan of payment fixed by the contract, that contract would be an investment contract within the spirit but not the letter of the legislation.

17.19 While we have concluded, for the reasons indicated in the preceding paragraph, that the definitions of investment contracts used in existing legislation should be changed, the changes we propose would have no effect on the present scope of the legislation. Every company treated as an investment contract company at the time of writing would continue to be so treated and we are aware of no other company presently carrying on business which would be so treated under our proposed definition. The purpose of the changes, which are discussed in paragraphs 18.05 to 18.10 is to prevent the organization of a company which in fact carries on the investment contract business but is not regulated as such because it does not satisfy the technical requirements of the statutory definitions.

Regulation of Investment Contracts

17.20 The five provinces referred to in paragraph 17.16 are the only provinces with legislation specifically applicable to investment contracts. In the others, investment contract companies are regulated by the securities administrators under securities legislation. This is true of Manitoba, but in that province the Securities Commission is given additional

authority by the special Acts of the Manitoba legislature under which Investors Syndicate, Limited and The Western Savings and Loan Association were organized. In the provinces without specifically applicable legislation, the securities administrators use their discretionary authority to apply requirements which are substantially similar to those contained in the relevant statutes of the other provinces.

17.21 Each of the five provinces with investment contract legislation, except Alberta, entrusts administration of the statute to the provincial Superintendent of Insurance. This reflects the philosophy of the legislation, which emphasizes the importance of the availability of adequate reserves to meet liabilities. This stress on reserve requirements also characterizes the regulation of life insurance companies. In each case, the contracts or policies issued involve long-term liabilities to investors who look to those liabilities as an important part of their savings. It is therefore important for the organizations concerned so to conduct their affairs that they will be able to meet their obligations as they fall due. With this objective, reserve requirements are designed to prevent them from taking undue risks in the investment of the money received, and more importantly, to prevent them from distributing that money by way of dividend or otherwise to such an extent that their remaining assets will be insufficient to meet their liabilities. The requirements endeavour to accomplish these objectives by specifying that assets must be maintained with a minimum value which bears a certain relationship to outstanding liabilities, and by restricting the investments which may be included in these assets. The assets maintained in satisfaction of these requirements are referred to as the company's "reserves".

17.22 For investment contract companies, the value of assets to be maintained as reserves is the greater of the amounts arrived at by alternative formulas. The first is apparent: reserves at any time must be at least equal to the amount which the investment contract company is liable at that time to pay to the holders of all its investment contracts then outstanding. This is referred to by us as the "cash surrender value" formula. The alternative formula, referred to by us as the "maturity value" formula, governs if it

results in a higher reserve requirement. This formula is more complicated. As stated in The Investment Contracts Act (Ontario) it requires a company to:

> 10(a) ...maintain reserves for the payment of its outstanding investment contracts that, together with all future payments to be received by the issuer on such investment contracts, or the portions of such future payments still to be applied to reserves, and with accumulations of interest at an assumed rate provided in the contracts, such rate not to exceed a rate approved by the Superintendent, will attain the face or maturity value specified in the contracts when due, or the amount payable in accordance with the terms of the contracts;...

The alternative formulas are applied on an aggregate basis. The implications of this can be appreciated if two contracts are considered. At a particular time, the first has a cash surrender value of $175, but application of the maturity value test would produce a reserve requirement of $195. For the second contract, the corresponding figures are $210 and $200, so that its cash surrender value requirement is higher than its maturity value requirement. If these were the only investment contracts a company had outstanding, its total reserve requirement at that time would be $395. If the tests were applied on a contract-by-contract rather than an aggregate basis, the requirement would be increased to $405.

17.23 The purpose of the cash surrender value formula is to require the company to maintain reserves with a value which at all times is at least equal to the total amount for which it is then liable to holders of investment contracts. The maturity value formula is designed to reduce a temptation which, if yielded to, might have serious adverse consequences. A company anxious to increase its business might pay its salesmen the entire excess of the initial payments on an instalment investment contract over the cash surrender value, even though it was aware that subsequent payments would not be sufficient to produce the amount payable on maturity. The company would instead rely on being able to make up the difference by payments received from new purchasers of investment contracts. That practice is made more difficult by the application of the requirement that reserves must be maintained which are sufficient, together with promised future payments, to pay off the contract on maturity. It might seem that the administrator who is responsible for the determination of the maximum reserve accumulation rate should fix it at a low rate to provide maximum protection for contract-holders. It is apparent that, the lower the

permitted reserve accumulation rate, the greater the amount of money that must be held in reserve under the maturity value test. However, to determine an unduly low maximum reserve accumulation rate may force investment contract companies to promise a lower rate of return under their contracts than would otherwise be the case.

17.24 The decision by an investment contract company as to the rate of return to be promised under a contract is a complicated process in which several factors interact. This is particularly true of instalment investment contracts. The most important of such factors are the maximum reserve accumulation rate established by the administrator; the promised rate of return under the contract; salesmen's commission; administrative expenses; and the anticipated actual yield on reserves. The relevance of administrative expenses and the anticipated actual yield on reserves is apparent, for each has a direct effect on the profitability of the company. The maximum permissible reserve accumulation rate is also a significant factor, although an increase in that rate would not necessarily result in an increase of promised rates of return. An increase in the reserve accumulation rate would not change the amount required to be maintained as reserves in any case where application of the cash surrender value formula produced a higher reserve requirement than application of the maturity value formula. Such an increase would therefore almost certainly not produce an increase in promised rates of return. If the maturity value formula was determinative of reserve requirements, the increase would result in a reduction of the minimum reserves and would thereby make assets available for other uses. However, the company might decide to increase salesmen's commission rather than the promised rate of return. These two factors, salesmen's commission and rate of return, are closely related. The influence of salesmen's commission on promised rate of return is affected both by the amount of the commission and by the way it is spread over the life of a contract. An increase in the commission paid initially, with a consequent reduction in the amount of money added to reserves at the outset to accumulate through the life of the contract, can have a more major impact on promised rates of return than a larger increase which is paid to the salesman by instalments over a period of years.

17.25 An important consequence of the reserve requirements has been to encourage the investment contract companies to place considerable reliance on additional credits, which are amounts credited by most companies to their outstanding contracts annually although there is no commitment to do so under the contracts. These additional credits play a role similar to that of dividends paid by life insurance companies to their policyholders. They reflect the allocation to holders of debt instruments of a portion of the excess earned on their investment over the promised rate of return. They can be varied in amount from year to year, although in practice investment contract companies tend to maintain them at the same rate throughout the life of the contract. Additional credits also have the advantage that, since they are not payments which the company is required to make under the contract, reserves need not be established for them until they become actual liabilities. For these reasons, additional credits are used by many companies, and often represent as much as one-half of the yield to the holder of an investment contract in excess of the amount he pays. Table XVII-A, which appears after paragraph 17.34, provides an example of the size of additional credits.

17.26 The maximum reserve accumulation rates permitted by administrators vary between provinces. The effective rates at the time of writing in Ontario were established by the Superintendent of Insurance in 1966. They are:

Single pay contracts up to 10 year term	5%
Instalment contracts up to 5 year term	5%
Instalment contracts 6 to 15 years	4-1/2%
Instalment contracts over 15 year term	4%
Extended benefits after maturity of contract	3-1/2%

Most of the Western provinces have a maximum rate of 4-3/4% for all contracts, although the administrators have exercised their discretion to allow rates for specific contracts of up to 7%. During our conversations with industry representatives, one of the points to which they gave most emphasis was that, in their opinion, these rates should be increased.

17.27 While the statutory formulas outlined in paragraph 17.22 for the determination of the value of investments required to be held in reserve are adequate in principle, we have concluded that they require amendment

on a number of points of detail. Our specific criticisms, and the remedies we propose, are discussed in paragraphs 18.50 to 18.52.

17.28 As noted in paragraph 17.21, requirements should deal not only with the value of assets to be held as reserves, but also with the nature of the investments which may be included in those assets. Both points must be resolved if adequate protection is to be provided. Yet the latter requirements, as to the classes of investments in which reserves may be maintained by investment contract companies, are not sufficiently dealt with by existing statutes. Legislation concerning permissible investments to constitute reserves should resolve three questions: the classes of assets permissible; the percentage allocation among classes (for example, a provision that no more than a specified percentage of the reserves may be invested in common stock); and the valuation of assets. The Canadian statutes applicable to investment contract companies deal with the first point, although sometimes unsatisfactorily. Some statutes, for example, permit investment contract companies to invest their reserves in any assets permitted under any of several other statutes, although such statutes may be inconsistent. None of the Canadian statutes applicable to investment contract companies deals adequately either with the allocation of the reserves among classes of assets, or with their valuation. In paragraphs 18.56 to 18.58 we advance proposals designed to resolve this problem.

17.29 Most of the statutes restrict not only the investments in which reserves may be maintained, but also the investments that may be made by the company with those of its assets that are not necessary to establish reserves. The result of such a restriction is that a company which has assets of a total value greater than those required to establish its reserves must accept restrictions in the investment of its surplus assets which are identical or similar to those applicable to the investment of reserves. For reasons indicated in paragraph 18.63 we consider the desirability of such restrictions to be closely related to the question of whether investment contract companies should be required to maintain a minimum amount of capital in excess of the reserves. A minimum capital requirement is designed to provide additional

protection for contract-holders; if the reserves are insufficient to satisfy their claims, such a requirement should result in the availability of additional resources for the purpose.

17.30 The province of Saskatchewan is the only jurisdiction with a statutory minimum capital requirement, other than a requirement which specifies a fixed dollar amount of minimum capital. By a 1969 amendment* to The Investment Contracts Act (Saskatchewan), investment contract companies are required to maintain, over and above their statutory reserves, a net worth, as defined, bearing a specified proportion to liabilities. Dividend payments are prohibited if they would result in a contravention of the requirement. We understand that other provinces impose a similar requirement on a discretionary basis; in Ontario, the equity of an investment contract company must be not less than 5% of total liabilities. The purpose of such requirements is to provide the contract-holder with additional protection in excess of the reserves. They are commented on in paragraphs 18.61 to 18.64.

17.31 While Saskatchewan's requirement is unique in Canada, several provinces require investment contract companies to maintain a specified minimum capital stated as a fixed minimum dollar amount rather than as a proportion of outstanding liabilities or by another formula. The most rigorous of these minimum capital rules is in Alberta, which requires that an investment contract company's "paid-in capital, paid in surplus and earned surplus, or any one or more of them amount in the aggregate to $500,000". The Alberta Securities Commission has authority to reduce this to as little as $250,000. Most of the other provinces use $200,000 as the minimum capital required.

17.32 The reserve and minimum capital requirements are by far the most important of the provisions in the statutes applicable to investment contract companies. There are, however, additional provisions which should be noted. Forms of investment contracts must be filed with administrators, who have a rarely exercised power to disapprove them. Regular reports on the companies' financial affairs must also be filed with administrators. Salesmen must obtain licenses, but no examinations are imposed and it is rare for a

* Statutes of Saskatchewan, 1969, chapter 68.

license to be refused. In the provinces where securities legislation governs investment contract companies, prospectus requirements are applicable in theory, but in practice exemptions are provided from those requirements. In the Province of Quebec a "brochure" must be prepared and delivered to potential purchasers.

17.33 The adequacy of the existing regulatory structure can best be judged on the basis of what happens in practice under the legislation. In the following section, we describe in general terms the provisions of investment contracts currently available. We then comment on interest rate disclosure. Finally, we summarize the results of a study we conducted of the actual experience under instalment investment contracts.

Provisions of Investment Contracts

17.34 In view of the fact that the basic arrangement embodied in an investment contract can be briefly described as a promise by the issuer to pay a specified amount on maturity in exchange for a payment or payments made by the contract-holder, it would be reasonable to assume that the terms of such contracts would be comparatively simple. They are in fact very complex, particularly in the case of instalment investment contracts. The complexity is attributable to two factors. There is no general code which governs the relationship of the contract-holder to the company, equivalent to the applicable corporations act with incorporated mutual funds or the applicable trust instrument with unincorporated mutual funds; the investment contracts acts do not purport to fill this role. It is therefore necessary for all terms of the relationship to be spelled out in the contract. Secondly, the details of the arrangement are themselves complicated. The various circumstances that can arise during the life of the contract, as well as the alternative benefits available on maturity, all require careful explanation. In the following paragraphs we describe the matters usually dealt with in investment contract provisions, although details vary considerably.

TABLE XVII-A

PAYMENT ARRANGEMENTS UNDER A TYPICAL 15-YEAR

INSTALMENT INVESTMENT CONTRACT

			Promised Rate of Return				Rate of Return Including Additional Credits	
Year	Paid-In Amount (Note 1)	Cash Surrender Value (C.S.V.) (Note 2)	Annual Compounding	Semi-Annual Compounding	Additional Credits (A.C.) (Note 3)	C.S.V. & A.C.	Annual Compounding	Semi-Annual Compounding
1	$ 52.20	$ 00.00	-100%	-200%	$ 00.00	$ 00.00	-100%	-200%
2	104.40	52.77	- 98.91	-179.07	.79	53.56	- 97.39	-167.70
3	156.60	109.30	- 34.07	- 37.61	2.44	111.74	- 32.08	- 35.16
4	208.80	168.16	- 14.29	- 14.84	5.00	173.16	- 12.37	- 12.77
5	261.00	229.45	- 6.45	- 6.55	8.52	237.97	- 4.62	- 4.67
6	313.20	293.27	- 2.64	- 2.65	13.05	306.32	- .89	- .89
7	365.40	359.72	- .52	- .52	18.64	378.36	1.16	1.16
8	417.60	428.91	.76	.75	25.35	454.26	2.39	2.38
9	469.80	500.96	1.60	1.59	33.24	534.20	3.18	3.15
10	522.00	575.98	2.17	2.16	42.38	618.36	3.71	3.68
11	574.20	654.09	2.57	2.56	52.83	706.92	4.08	4.04
12	626.40	735.42	2.87	2.85	64.65	800.07	4.35	4.30
13	678.60	820.11	3.10	3.07	77.92	898.03	4.54	4.50
14	730.80	908.29	3.27	3.24	92.71	1,001.00	4.69	4.63
15	783.00	1,000.00	3.40	3.37	109.10	1,109.10	4.79	4.74

NOTES

1. The paid-in amounts assume annual payments made at the beginning of each year. If made on a monthly basis, the required payments would be $4.70 monthly or $56.40 annually, so that the rate of return would be reduced.
2. Each cash surrender value takes effect at the year-end and remains in effect for the following year. There is no proportionate increase if a contract is terminated between year-ends.
3. Additional credits are projected at the rate currently being paid. There is no assurance that the company will continue to pay this rate.
4. The contract-holder has the right at any time to receive a paid-up contract which will mature at the maturity date of the original contract and will have a maturity value of the then cash surrender value plus accumulated additional credits, all accumulated at 3% interest to maturity.
5. The rate of return information has been calculated by the staff of the Committee, on the basis of the other information which is derived from the contract. The semi-annual compounded figures are expressed on a nominal basis.

17.35 Table XVII-A illustrates the provisions of a typical instalment investment contract, with a fifteen-year term. While contracts are available with terms of from five to twenty years or more, fifteen years is a popular term and the information in the table may be taken as representative although the various available contracts differ in detail. The rates of return and other information included in the table assume complete compliance by the contract-holder with the terms of the contract, particularly in making payments on schedule. If the holder delays in making a payment, his rate of return is adversely affected for two reasons. First, no interest accumulates during the period of the delay; in order that the amount payable on maturity will not be affected, the maturity date of the contract is correspondingly extended. Second, additional credits are declared only when the holder has completed a year's payments, and they are declared at a predetermined rate which does not reflect the fact that more than a year may have elapsed since the previous declaration. The practical consequences of these factors are vividly illustrated by some of the figures in paragraphs 17.49 to 17.54 which reflect actual experience under instalment investment contracts.

17.36 Table XVII-A illustrates most of the important features of instalment investment contracts, and the terminology they contain. The relationship among the various elements of the contract is representative of industry practice except that a few companies, under a few contracts, do not pay additional credits. There are, however, many differences in the details of procedures followed. For example, some companies do not penalize the contract-holder who is less than, say, thirty days late with a payment; others will suspend the accumulation of interest and extend the maturity date following a delay of even a few days. Calculation of additional credits also differs among companies. All follow the practice of applying them only to contracts for which the full year's payments have been completed, and only when these payments are completed. However, in some cases, the additional credits are and in other cases they are not applied to previously declared additional credits. In the example in Table XVII-A, additional credits are declared as 1-1/2% of cash surrender value annually, and no allowance is made for previously declared

additional credits. If additional credits are regarded as interest, the contract-holder is to this extent denied the benefit of interest on interest.

17.37 Table XVII-A and the preceding two paragraphs relate entirely to the instalment investment contract as a vehicle for the accumulation of money and its payment at maturity. They do not deal with the various other features of such contracts. For example, the contracts include a "prepayment provision" permitting the holder to pay an amount in excess of the amount then payable under the contract; this excess amount is retained by the company in a separate, interest-bearing account for subsequent application to the contract. Another feature of the contracts is the right to receive a paid-up certificate instead of completing the originally agreed payments; this right is described in Note 4 to Table XVII-A. Practices differ among the companies as to whether the holder of a paid-up certificate receives the benefit of additional credits declared after the date upon which he receives the certificate.

17.38 Arrangements for optional settlement, cash surrender or loan values prior to or after maturity also differ among contracts. The most frequent optional settlement is an annuity, for a term of years rather than for life since the investment contract companies lack power to issue life insurance contracts. Some investment contracts are specifically designated as annuity contracts; to receive cash under these contracts requires the selection of an alternative to the annuity which would otherwise be received automatically.

17.39 Most, but not all, investment contracts contain loan provisions. The older contracts bind the company to make a loan on the security of the contract but the present practice reserves an option in the company as to whether it will or will not effect a loan, and as to the interest rate it will charge if it does make a loan on the security of an investment contract. In practice, loans on the security of contracts have been comparatively infrequent in recent years.

17.40 Apart from the elements which are characteristic of investment contracts generally, the contracts issued by some companies contain special features. One company, Savings and Investment Corporation, offers a

contract under which the contract-holder's payments are allocated, in proportions determined by him, between the purchase of mutual fund shares or units and the purchase of an investment contract. Several other companies offer the contract-holder the right to liquidate his investment contract and to transfer the proceeds to a mutual fund without payment of sales charges. These are examples of the endeavour to adapt contracts to provide a package more attractive to potential investors.

17.41 The problems of the contract-holder who does not complete his contract and may be faced with a loss of money are reduced, although far from eliminated, by policies followed by most of the industry. Most investment contract companies will refund the initial payment to the contract-holder on request received within 30 days after the issuance of the contract. Many contracts include a provision whereby, if the total amount of payments under a contract is greater than the current cash surrender value plus accumulated additional credits at a time when the holder dies or becomes permanently disabled, then the company will refund the higher amount. This "death or disability" benefit is available regardless of whether the contract-holder also purchases completion insurance. In addition to the death or disability benefit, the two companies with headquarters in Halifax have included features in their contracts designed to benefit the holder who terminates voluntarily at a time when the total of the payments he has made is greater than his cash surrender value. Keltic Savings Corporation Limited allows such a contract-holder, provided he has completed one full year of payments, to elect whether to receive his cash surrender value immediately or to receive an amount equal to the total of payments made, but not until the maturity date of the contract. Service Investments Corporation Limited will pay cash surrender value immediately, and will in addition deliver to the contract-holder a promissory note payable at the maturity date of the contract for an amount equal to the excess of payments made over cash surrender value.

17.42 The reasons for the complexity of instalment investment contracts are apparent from the preceding paragraphs. The necessary explanations of additional credits; cash surrender values; prepaid certificates; advance de-

posits against future payments; death or disability benefits; loan privileges; various optional settlements; and any additional arrangements, consume considerable space. While the complicated nature of the contracts is therefore understandable, it is to be hoped that more will be done to explain their provisions to purchasers. This point is dealt with in the recommendations made in the following chapter.

Interest Rate Disclosure

17.43 In the selection of a mutual fund for investment, the informed purchaser must take a variety of factors into account. Investment objectives, quality of investment management, and level of sales charges and management fees are the most important considerations but not the only ones. The important points to be considered by the informed purchaser who wishes to invest his savings dollars in a debt instrument of a financial institution are fewer in number. Security and rate of return far surpass other aspects of the instrument in importance; secondary considerations are the degree of liquidity provided by the instrument and the additional privileges which it carries, such as optional settlements. The attention of the knowledgeable purchaser in his selection among competitive debt instruments will be concentrated on the proper balance between security and rate of return; his analysis in this respect may be very similar to that performed by the knowledgeable mutual fund investor who uses techniques such as those described in Chapter III to arrive at the combination of risk and rate of return which is appropriate for him.

17.44 The purchaser for whom investment contracts are unsought goods will not make the type of analysis contemplated by the preceding paragraph. This is impliedly acknowledged by the following quotation from a letter prepared by one company to comment on a memorandum concerning disclosure of interest rates which was circulated by us. The quotation is representative of the industry's position:

> With respect to the comments on instalment contracts there seems little point in arguing interest rate as the products we are selling is not investment income but savings programs. The whole investment contract industry is predicated on the accumulation of capital and the interest factor is at best a secondary consideration.

> To argue otherwise seems pointless as obviously no investment contract company would remain in business 5 years if the product appeal was limited solely to the interest earned on the savings. Where a person saves $10.00 a month for a period of 10 years the service you have rendered is assisting him to accumulate $1,300 and that is far more important than whether or not he is receiving 3% or 4% compound interest.

17.45 In keeping with the approach reflected in the quotation in the preceding paragraph, instalment investment contracts and the sales literature used in their distribution frequently do not refer to interest rates or rate of return. They emphasize instead the amount the contract-holder will receive if he completes his payments. This figure is often expressed as a percentage of total payments made, so that the holder of the instalment contract described in Table XVII-A is told that on maturity he will receive 118% of his total payments, or over 127% if allowance is made for additional credits. Another letter received in reply to our request for comments on a staff memorandum concerning interest rate disclosure said:

> ...accumulation investment certificates are not sold on the basis of interest rate but rather because the individual sets out to realize a specific savings goal. For this reason the disclosure of interest rates is not in our opinion a necessity...

The difficulty with this approach is that if no information is published concerning the effective interest rate provided under a contract, the potential purchaser is not alerted to the question of interest rates unless he addresses his mind specifically to that question.

17.46 With single payment investment contracts, sales literature frequently includes an expression of interest return on a "simple interest" basis. Table XVII-B illustrates the significance of this method of disclosure through the use of a representative twenty-year contract. It is apparent from an analysis of that table that the use of simple interest can result in a substantially higher apparent rate of return than would be true under the more traditional methods of computation. The practice of reflecting projected additional credits in the calculation although the company is not legally obligated to pay them further increases the resultant rate.

TABLE XVII-B

PAYMENT ARRANGEMENTS UNDER A TYPICAL 20-YEAR

SINGLE-PAYMENT INVESTMENT CONTRACT

($10,000 Investment at the Beginning of Year 1)

			Rate of Return Including Additional Credits	
Year	Cash Surrender Value (C.S.V.)	Additional Credits (A.C.)	Semi-Annual Compounding	Simple Interest
1	$10,300	$ 52.00	4.47%	3.52%
2	10,720	108.20	4.49	4.14
3	11,150	168.80	4.47	4.40
4	11,610	234.10	4.49	4.61
5	12,080	304.40	4.49	4.67
6	12,670	379.90	4.49	5.08
7	13,180	461.00	4.49	5.20
8	13,720	548.10	4.49	5.34
9	14,270	641.40	4.49	5.46
10	14,840	741.30	4.48	5.58
11	15,440	848.10	4.48	5.71
12	16,060	962.30	4.48	5.85
13	16,710	1,084.30	4.48	5.99
14	17,380	1,214.60	4.48	6.14
15	18,070	1,353.50	4.48	6.28
16	18,800	1,501.60	4.48	6.43
17	19,550	1,659.40	4.47	6.58
18	20,340	1,828.50	4.47	6.76
19	21,150	2,007.40	4.47	6.92
20	22,000	2,197.70	4.47	7.10

NOTE: The cash surrender values shown are those applicable at the end of each year, and additional credits are declared only at the end of each year.

17.47 In a report made to us, one of our consultants, Professor J. Peter Williamson, commented as follows on the use of simple interest rates:

In the case of lump sum investment contracts, where the purchaser makes a single payment for the contract but may surrender it before maturity, he is generally given a table of cash surrender values, indicating what the proceeds on surrender will be at the end of one year, two years, and so on up to maturity. As a general rule, the investor is not provided with the interest rate or "yield" corresponding to these values. To calculate the yield for each value requires access to a book of interest rate tables and the skill to use these. It seems unlikely that the average purchaser of a lump sum contract is in any position to make this calculation for himself. However, without knowing what interest rate the company has guaranteed him, the purchaser has no basis for comparing the contract with other forms of guaranteed savings, such as savings accounts, bonds,

mortgages, or investment contracts issued by other companies. All that he can tell from the table of cash surrender values is how many dollars he will receive at some future date above the amount he has paid for the contract.

The Income Tax Act seems to provide a justification for omitting from the face of an investment contract any statement of the rate of return the contract offers. But this does not preclude disclosure of this rate in sales literature, and in fact a number of companies do furnish a prospective purchaser with what they call "simple interest" rates of return. Some companies disclose only the simple interest rate of return to maturity, that is, the simple interest rate that will be earned by the investor provided he holds his contract to maturity. But some companies also provide a table of simple interest rates of return, showing the rate that will be earned if the contract is surrendered at the end of one, two, three years, and so on, as well as the rate to maturity.

"Simple interest" rates of return are at best meaningless and at worst seriously misleading. When an investment contract company refers to a simple interest rate of 5.02% to maturity on a fifteen-year contract, it is actually saying that the annual rate of interest the purchaser will receive, if he holds the contract to maturity, is 5.02% compounded every fifteen years. And when the rate to maturity on a twenty-year contract is quoted as 5.36% simple interest, this means that the investor will earn 5.36% a year, compounded every twenty years. Even these two rates are not comparable. An annual rate compounded every fifteen years can only be compared directly to another annual rate compounded every fifteen years. To achieve comparability, we have to convert the rates to make the compounding frequency the same. A rate of 5.02% compounded every fifteen years is equivalent to a rate of 4.07% compounded semi-annually. And a rate of 5.36% compounded every twenty years is equivalent to 4.04% compounded semi-annually. The 4.07% and 4.04% rates are directly comparable, and perhaps the most striking aspect of the comparison is the fact that the fifteen-year contract actually offers a higher rate of return than the twenty-year contract, although the simple interest rates suggested the opposite.

To convert a rate of interest compounded every fifteen years to a rate compounded semi-annually almost requires a computer, or a set of logarithm tables. And although the calculation is not very complex it is probably well beyond the abilities of the average purchaser of an investment contract. Indeed, it seems unlikely that the average purchaser would even know the difference between compounding semi-annually and compounding every fifteen years, and he is probably happy to accept the "simple interest" rates as a measure of the profitability of a contract.

17.48 The reference made by Professor Williamson to the Income Tax Act involves the treatment for income tax purposes of the amount paid on maturity of an investment contract. It is apparent that the amount constitutes in part a return of invested capital, and in part a payment for the use of that capital. Under general principles of Canadian income tax law, the latter element should, and the former should not, be taxable as income to the recipient. Under the Act, that result is attained in different ways depending upon whether the relevant rate of interest is specified in the contract. If it is specified,

the interest element payable on maturity is taxable as income under section 6(1)(b) and other relevant provisions. If it is not so specified the special provisions of section 7 are applicable and a reasonable allowance must be made for interest. In the latter case, but not in the former, the recipient receives the benefit of section 35, which allows the tax on the interest element of the payment to be computed as if it had been received over a three-year period. The importance of this benefit is such that the companies can strongly argue that to set out an interest rate in the contract would result in a significant tax disadvantage to the contract-holder.*

Experience Under Instalment Investment Contracts

17.49 Representatives of investment contract companies with whom we had discussions uniformly acknowledged that the rates of return under instalment investment contracts were comparatively low, but stressed that this is not the important factor in a study of the industry. What is important, in their view, is that the instalment investment contract facilitates saving by persons who would not otherwise save money. The quotation in paragraph 17.44 is typical of the comments we received to this effect. We decided at an early stage of our work that this argument should be tested by an analysis of the actual experience under instalment investment contracts, to determine the extent to which the average contract-holder benefits from his investment. The analysis was conducted by the staff of the Committee and one of our consultants, Professor Williamson, on the basis of data collected on a voluntary basis from the companies concerned.

17.50 Many decisions were necessary in the formulation of the analysis. For a complete study of the full history of contracts, it would have been necessary to work with contracts issued twenty or more years prior to the date of the study. Results of such an analysis would, however, be open to the criticism that they did not represent the current practice because of changes in sales techniques and industry standards during the intervening period. In addition, most of the companies currently operating in Canada did not exist twenty years ago. We decided that the benefits of a complete history of

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* For an example of the application of these provisions, see Peers v M.N.R. 66 D.T.C. 158 (Tax Appeal Board, 1966).

long-term contracts should be surrendered in favour of information which would be more representative of current practices in the industry as a whole. The study concentrated on contracts issued in February, 1957 and August, 1962.

17.51 The second principal difficulty was in the decision concerning the information to be obtained, and the methods to be used to present the resultant data on a uniform basis. The variations between contracts are very considerable. Contract-holders are permitted to change their methods of payment, and often do change from monthly to semi-annual or some other basis. Delays in payments with resultant discrepancies in maturity dates also arise frequently. The selection of various optional settlements either on maturity or during the term of the contract is another area of difference among contracts. We engaged in discussions with representatives of the industry before we determined upon an approach which did not fully reflect all individual variations but was more than adequate to provide us with the data we required.

17.52 Our approach was to ascertain the amount invested to December 31, 1967 by the holder of each instalment investment contract being studied, and the value of his contract at that date. The former figure was simply the total of all payments and contributions made by the holder under the contract, without allowance for the time of payment. The latter figure, in the case of a contract terminated prior to December 31, 1967, was the amount paid on termination, and in the case of a contract still outstanding at that date it was the cash surrender value. A gross rate of return was computed through the use of these figures. It should be emphasized that the rates of return so arrived at are not annual rates, but directly relate total payments to the then cash surrender value plus additional credits under the contract, or to the amount received on its prior termination. If a total of $100 was paid under a contract and the cash surrender value at December 31, 1967 was $110, the rate of return used is 10% regardless of whether the contract was issued in February, 1957 or August, 1962 and regardless of the dates upon which the payments totalling $100 were actually made.

17.53 The information on rates of return under instalment investment contracts facilitated two kinds of analysis. The first, based on comparisons with what the rates of return would have been if payments had been made in compliance with the terms of the contract, enabled us to judge the merits of the argument that these contracts contribute to forced savings. The second, based on inspection of the results themselves, assisted us in a decision as to whether the terms of these contracts are so inconsistent with the best interests of investors as to make the imposition of substantive controls desirable. We here summarize the results of these analyses; proposals based on them are included in the next chapter.

17.54 Table XVII-C concerns only one investment contract company. The rates of return attained by the holders of instalment investment contracts issued by this company were superior, on average, to those of any other company studied and this table is included in preference to a set of tables representing every company. With some of the other companies the results were considerably less favourable. This is adequately indicated by a comparison between the information concerning terminated contracts in Table XVII-C and the comparable information concerning terminated contracts of another company which is provided in Table XVII-D. In our opinion, the results demonstrated by the tables speak for themselves and require no further explanation or discussion here.

TABLE XVII-C

EXPERIENCE UNDER INSTALMENT INVESTMENT CONTRACTS

ISSUED BY ONE COMPANY

IN FEBRUARY, 1957 AND AUGUST, 1962 (NOTE 2)

Average Return as % of Amount Paid in from Date of Issue to End of 1967

(Numbers in parentheses are total number of contracts concerned)

Date of Issue	Term	Total No. of Contracts (Note 2)	Matured or Terminated (Notes 3,4)		In Force (Note 4)		All Contracts
			% Return	No.	% Return	No.	% Return
Feb. 1957	6 yrs.	17	5.0	(17)			
" "	10 "	46	8.9	(46)			
" "	15 "	257	- 9.4	(152)	13.4	(105)	4.8
" "	20 "	325	- 8.6	(243)	10.6	(82)	.24
Aug. 1962	6 "	17	- .6	(6)	9.5	(11)	8.2
" "	10 "	52	-23.4	(22)	.6	(30)	- 4.9
" "	15 "	142	-36.0	(58)	-11.1	(84)	-15.7
" "	20 "	388	-44.9	(225)	-18.2	(163)	-25.5
			(Note 6)				
" "	10 "	4	- 5.1	(2)	4.2	(2)	- 2.4
" "	15 "	8	-14.2	(5)	- 8.4	(3)	-10.7
" "	20 "	32	-29.4	(11)	-16.6	(21)	-18.8

NOTES

1. The method of analysis is described in paragraphs 17.51 to 17.53. Two facts there noted are of particular importance to an understanding of the information presented. The rates of return shown are not annual, but gross; if the contract-holder pays $100 and has a cash surrender value at the end of 1967 of $110, the rate of return is 10% regardless of the number of years involved. Secondly, of the contracts considered only those issued in February, 1957 with maturities of 6 and 10 years were, by their terms, expected to attain maturity prior to the end of 1967.
2. The contracts considered are those issued by only one company studied, the company with the most favourable results of those analyzed. This company, by arrangement, supplied information only as to a representative sampling of its contracts, so that the numbers of contracts do not reflect all those sold during the months considered.
3. Contracts issued but on which nothing was paid by the purchaser are not included, although contracts issued but rescinded with return of all money paid are included. Of the 17 6-year contracts sold in February, 1957, and which should have matured before the end of 1967, 5 actually matured. 8 were surrendered for cash; 2 were automatically cashed after a year's payments

TABLE XVII-C (CONT'D)

EXPERIENCE UNDER INSTALMENT INVESTMENT CONTRACTS

ISSUED BY ONE COMPANY

IN FEBRUARY, 1957 AND AUGUST, 1962 (NOTE 2)

Theoretical Return Assuming Punctual Payments as % of Amount Paid in from Date of Issue to End of 1967							
Based on Cash Surrender Value				Based on Cash Surrender Value Plus Additional Credits (Note 5)			
Monthly Pmts.	Quar. Pmts.	Semi. Pmts.	Annual Pmts.	Monthly Pmts.	Quar. Pmts.	Semi. Pmts.	Annual Pmts.
(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)
3.2	4.1	5.1	7.2	7.0	8.0	9.1	11.2
7.9	8.9	11.0	13.3	14.4	15.4	17.6	20.0
5.1	6.0	8.3	10.5	11.0	12.0	14.4	16.7
3.5	4.5	6.9	9.1	9.3	10.3	12.9	15.2
4.8	5.6	6.6	8.2	8.4	9.0	10.1	11.4
- 4.8	- 3.9	- 1.0	- 2.5	- 1.7	- .8	2.2	5.5
-16.4	-14.9	-12.4	- 8.3	-13.9	-12.5	-10.0	- 5.9
-22.1	-20.1	-19.0	-15.2	-19.9	-18.7	-16.8	-13.1
- 4.8	- 3.9	- 1.0	2.5	- 1.0	- .2	2.8	6.1
-16.4	-14.9	-12.4	- 8.3	-13.4	-12.1	- 9.5	- 5.5
-22.1	-20.1	-19.0	-15.2	-19.5	-18.3	-16.3	-12.7

were missed; 1 was automatically converted to a paid-up certificate; and 1 was terminated for an overdue loan. Of the 46 10-year contracts sold in February, 1957, and which should have matured before the end of 1967, 9 actually matured. 24 were surrendered for cash; 4 were automatically cashed; 4 were rescinded within 30 days of sale; 1 was transferred automatically to a paid-up certificate; 1 was cancelled; and 3 contract-holders died.

4. The profit figures expressed in the column headed "Matured or Terminated" are based on the amount of cash or the cash surrender value of the paid-up certificate or optional settlement received at the time of maturity or termination. The profit figures expressed in the column headed "In Force" are based on cash surrender values plus additional credits at December 31, 1967 rather than on a realized amount.
5. The additional credits used are those actually declared.
6. Of the 225 20-year contracts sold in August, 1962 which were terminated prior to December 31, 1967, 80 represented losses of the entire amount invested, and 41 represented no loss because the entire amount paid was returned to the investor.

TABLE XVII-D

RATES OF RETURN UNDER TERMINATED OR MATURED INSTALMENT INVESTMENT CONTRACTS ISSUED BY ONE COMPANY IN FEBRUARY, 1959 (NOTE 2) AND AUGUST, 1962

Date of Issue	Term (Years)	Average Return as % of the Amount Paid in from Date of Issue to Maturity or Termination
February, 1959	5	+ 2.6%
" "	10	-19.4
" "	15	-22.3
" "	16	-29.2
" "	16.5	-37.9
" "	20	-40.3
August, 1962	6	- 9.8
" "	10	-15.4
" "	15	-32.5
" "	16.5	-51.9
" "	18.5	-55.7
" "	20	-60.0
" "	25	-72.7

NOTES:

1. The data in this table are comparable to the data concerning terminated contracts in Table XVII-C, with the exception noted in Note 2 and except for the fact that a higher proportion of the contracts in this table than in Table XVII-C may have resulted from transfers from other contracts. If that is correct, the result is to <u>increase</u> the rates of return shown in this table.

2. February, 1959 is used instead of February, 1957 because the company involved here was unable to supply information for contracts issued in the latter month. This should be taken into account in any comparison between this table and Table XVII-C; it would be reasonable to expect the return on contracts sold in February, 1959 to be lower at the end of 1967 than that on contracts sold in February, 1957.

3. Approximately 62% of the contracts sold by the company concerned were terminated by the end of 1967 and are reflected in this table.

4. The average return of +2.6% for five-year contracts sold in February, 1959 is based on 17 contracts. Of these, 4 actually matured; 6 lapsed; 5 terminated with requests by their holders for payment of cash surrender value; 1 was cancelled, and 1 was still being carried as an open contract at the end of 1967.

17.55 The conclusions we draw from the data provided in Tables XVII-C and XVII-D are amply confirmed by the additional statistical material we have reviewed. In our opinion, the discrepancy between the theoretical return under instalment investment contracts and the returns actually attained is sufficient to justify a rejection of the argument that these contracts force their holders to save and therefore provide them with a benefit. Further, the results are so poor as to justify, and indeed to necessitate, the enactment of provisions requiring substantive changes in the terms of contracts on behalf of the investing public. The drive to provide maximum compensation for salesmen has been carried to the point where investors suffer unduly as a result, and limits must be imposed for their protection. Our proposals as to the nature of these limits are set out in paragraphs 18.38 to 18.47.

CHAPTER XVIII

RECOMMENDATIONS CONCERNING INVESTMENT CONTRACTS

18.01 Investment contract companies are subject in most of Canada to regulations specifically designed for them, as are financial institutions which issue instruments directly competitive with investment contracts. This has been a significant factor in the formulation of our recommendations in this area; it constitutes another respect in which investment contracts differ from mutual funds, since most regulations specifically designed for mutual funds are applied by securities administrators through the exercise of their discretionary authority.

18.02 As Chapter XVII indicates, most of the legislation presently applicable to investment contract companies imposes requirements concerning matters traditionally dealt with by governmental controls applicable to debt instruments and their sale to the public. The most important such requirements are those which relate to reserves and to minimum capital. It is convenient for analytical purposes to consider these as one category, and to consider separately the type of requirements which are more traditionally included in securities legislations. The most important requirements of the latter type are those designed to result in adequate disclosure to holders and to potential purchasers of securities. In the formulation of our proposals concerning matters traditionally dealt with by legislation applicable to debt instruments issued by financial institutions, we have been aware of the desirability of uniformity in the

applicable legislation. We have accepted the Canadian and British Insurance Companies Act* as a model in certain areas, and propose that legislation applicable to investment contract companies should include provisions similar or identical to the corresponding provisions in that Act. In such cases, we have not attempted a detailed analysis of the relevant provisions. Changes in them should, we feel, result from a study conducted by a body with terms of reference wide enough to permit it to consider the two industries and any other types of financial institutions to which similar requirements are relevant.

18.03 In considering the second category of requirements referred to in the preceding paragraph, those traditionally included in securities legislation, it is necessary at the outset to resolve a contention strenuously advanced by the investment contract industry. This contention, discussed in paragraph 17.08, is that we should not propose requirements for application to investment contract companies unless similar requirements are applied to life insurance companies. The contention, as stated, is one we reject for the reasons set out in paragraph 17.08, but the arguments advanced in its support have influenced the conclusions reached in this chapter. We have formulated our recommendations to minimize any possible competitive disadvantage for investment contract companies by comparison with life insurance companies which might result from their implementation.

18.04 The following sections contain our recommendations for changes in the regulatory scheme presently applicable to investment contract companies. No attempt is made to consider all aspects of the scheme; in the absence of a specific recommendation to the contrary, we intend that the requirements presently in effect should be preserved. The discussion first deals with the definition of an investment contract company. Subsequent sections consider the distribution of investment contracts and applicable disclosure requirements, including disclosure of interest rates and additional credits; the rate of return to investment contract-holders; and reserve and minimum capital requirements.

* R.S.C. 1952, chapter 31, as amended by S.C. 1956, c. 28; S.C. 1957-1958, c. 11; S.C. 1960-1961, c. 13; S.C. 1964-1965, c. 40. Reference is also made to amending Bill S-35, introduced before the Senate on May 6, 1969.

Definition of an Investment Contract Company

18.05 In paragraph 17.04 we note as the two distinguishing features of investment contract companies that they provide optional settlements and that a large proportion of them are sold on an instalment basis. Only the former of these features forms part of the definitions used in the applicable provincial statutes, of which an example is quoted in paragraph 17.16. This feature, the inclusion of optional settlements in the contract, should in our opinion not be relied upon for definitional purposes. As indicated in paragraph 17.18, it is easy to envisage a contract which would be an investment contract within the spirit of the applicable legislation and yet would contain no optional settlements. It is noteworthy that under present law there is an advantage to be gained by establishing an instrument to be an investment contract, for an exemption from securities legislation is thereby made available in its distribution to the public. That advantage would be reduced or eliminated through the implementation of our proposals, and it is therefore important to modify the definition so that it will not be possible to avoid it through the creation of an instrument which would not be an investment contract merely because it did not satisfy one or more of the requirements itemized in paragraph 17.17.

18.06 There are two principal difficulties with the definitions of investment contracts described in paragraphs 17.16 and 17.17. The first is the assumption that an instrument is not an investment contract unless it contains optional settlements, cash surrender or loan values. The second is the attempt to include single payment contracts in the definition. There is little to distinguish such a contract from a promissory note or a similar instrument issued by any financial institution, and any attempt to define the single payment investment contract so as to distinguish it from such other instruments is doomed to failure. The crucial feature of an investment contract company is, in our opinion, the issuance of instalment investment contracts. A company which issues single payment contracts exclusively ought not to be treated as an investment contract company. It should instead be regulated as a trust company

or some other type of financial institution. A company should not be considered to be an investment contract company unless it issues instalment investment contracts, or has such contracts outstanding.

18.07 The conclusion that the issuance of instalment investment contracts should be the focus of the definition of an investment contract company accords with the realities of the situation. The issuance of instalment contracts enables an investment contract company to make a significant appeal to the smaller investor; its single payment contracts are often issued to holders of instalment contracts who wish to reinvest their money after maturity of the contract. A company which issued single payment contracts exclusively would appeal to a completely different market, and there would in our opinion be little or nothing to distinguish it from a trust company issuing guaranteed investment certificates.

18.08 The analysis in preceding paragraphs leads to definitions equivalent to the definitions of "face-amount certificate" and "face-amount certificate company" in the Investment Company Act of 1940. These read as follows:

> 2(a)15 "Face-amount certificate" means any certificate, investment contract, or other security which represents an obligation on the part of its issuer to pay a stated or determinable sum or sums at a fixed or determinable date or dates more than twenty-four months after the date of issuance, in consideration of the payment of periodic installments of a stated or determinable amount (which security shall be known as a face-amount certificate of the "installment type"); or any security which represents a similar obligation on the part of a face-amount certificate company, the consideration for which is the payment of a single lump sum (which security shall be known as a "fully paid" face-amount certificate).
>
> 4(1) "Face-amount certificate company" means an investment company which is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or which has been engaged in such business and has any such certificate outstanding.

18.09 The result of these definitions is that a company which issues or has outstanding instalment contracts is a face-amount certificate (investment contract) company, and that a single payment contract is a face-amount certificate (investment contract) if, but only if, it is issued by such a company. The definition also eliminates the requirement that an investment con-

tract must include "optional settlement, cash surrender or loan values prior to or after maturity," or "a plan of payment". Most face-amount certificates in fact include both optional settlements and plans of payment, and Canadian investment contracts would presumably continue to do so if these definitions were introduced here. The point is that the omission of these features should not alone prevent an instrument from being treated as an investment contract. As noted in paragraph 17.19, adoption of the definitions we propose would not result in a change in the status of any company carrying on business in Canada at the time of writing. All investment contract companies would continue to be regulated as such, and we are aware of no existing company that would be treated as an investment contract company under our proposed definitions which is not so treated under the present law. The principal consequence of the revised definitions would be to prevent the operation in the future of companies which carry on business essentially in the manner of investment contract companies but are not regulated as such because the instruments they issue fail to satisfy the definition of an investment contract in all respects.

18.10 Difficulties have arisen in the past when investment contract companies have carried on activities other than the issuance and distribution of investment contracts. Such activities may create conflicts of interest on the part of the management of an investment contract company, and can result in serious problems in the application of priorities among creditors. We have concluded that the business of investment contract companies should be restricted to the issuance and distribution of investment contracts and to related activities. The term "related activities" in this context should be construed sufficiently widely to permit the sale of investment contracts in combination with other financial instruments such as the shares or units of mutual funds.

18.11 For the reasons set out in this section, we recommend:

(1) that the term "investment contract company" should be defined to include any company which issues or has outstanding instalment investment contracts; that "instalment investment contracts" should be defined substantially in accordance with the definition of "face-amount

certificate of the installment type" in the Investment Company Act of 1940; and that a promise to pay by an investment contract company in exchange for an amount received as a single payment should be considered to be a single payment investment contract although a similar promise made by a company which is not an investment contract company should not be so considered; and

(2) that the business of an investment contract company, as defined, should be restricted to the issuance and distribution of investment contracts and to related activities; the term "related activities" should be construed sufficiently widely to permit the sale of investment contracts in combination with other financial instruments such as the shares or units of mutual funds.

<u>Distribution of Investment Contracts:
Disclosure Requirements</u>

18.12 The legislation presently applicable to investment contract companies, in keeping with the regulations traditionally applied to financial institutions engaged in the sale of debt instruments to the public, emphasizes reserve rather than disclosure requirements. This is in strong contrast with the regulation of mutual funds, which emphasizes disclosure. The difference is understandable, since reserve requirements in the usual sense would be inappropriate for mutual funds. However, the result is that the investment contract purchaser receives considerably less information than the mutual fund purchaser, and this difference in the quantity of information received would be even more pronounced if the proposals in Chapters IV to XV were to be implemented without the application of corresponding requirements to investment contracts. Of particular importance in this connection are the proposals in Chapters XIV and XV concerning disclosure, and those in Chapter X concerning public education designed to increase the shopping goods segment of the market for mutual fund shares or units.

18.13 Complete disclosure and effective competition are at least as important objectives in the context of investment contracts as in the context of mutual funds. We would reject any contention that these objectives

are less important because investment contracts are debt instruments. That fact is relevant to the nature and extent of the disclosure which should be required, but not to the principle of disclosure. Both in the short-term and in the long-term, full disclosure is necessary for adequate public protection. In the short-term, it is desirable to acquaint the investor with relevant information concerning his proposed purchase, so that he will be aware of its implications at the time of investment. In the long-term it is essential if the well-informed investing public which is so important to effective competition at the consumer level is to develop in Canada.

18.14 Disclosure is not alone sufficient to attain the objectives we think necessary in the regulation of the distribution process. It must be accompanied by educational programmes and by restrictions on sales practices. All of these requirements fall, to various degrees, within the second category discussed in the introductory paragraphs of this chapter, for all involve provisions of a type not customary in the regulation of financial institutions issuing debt instruments to the public. That does not dissuade us from our belief that they can and should be applied to investment contract companies. No representative of the industry has stated to us that more effective disclosure would prejudice investment contract companies. We would not be sympathetic with such a statement if it were made, for an industry which would be prejudiced by effective disclosure deserves little sympathy.

18.15 We have concluded that the proposals for disclosure, public education and control over salesmen which are made in Chapters X, XIV and XV for mutual funds are, in principle, equally appropriate for investment contract companies. The objectives which we think should be attained through the applicable regulations in the two industries are almost identical, and their common reliance on direct sales forces further accentuates the similarity of the requirements appropriate for those objectives. The fact that every investment contract salesman is also in a position to provide his customers with shares or units of mutual funds is another relevant consideration in support of uniform disclosure requirements.

18.16 Perhaps the most important provisions to be applied so that adequate disclosure will be made to the purchaser of an investment contract are those outlined in Chapter XIV concerning prospectuses, summary prospectuses, rescission rights and confirmations of transactions. The reasons for each of these provisions are as relevant to investment contracts as to mutual funds. The requirements concerning the delivery of prospectuses, summary prospectuses and confirmations can be applied unchanged to investment contract companies. The distinction made in these requirements between contractual plans and lump sum purchases should be reflected in a corresponding distinction between the rules applicable to instalment investment contracts and those applicable to single payment contracts. Rescission rights should also be granted to the purchasers of investment contracts on the same basis as to mutual fund investors, except that the amount to be paid by an investment contract company to a purchaser who validly exercises a right to rescind should be the full amount of the payment made under the investment contract without allowance for subsequent price fluctuations.

18.17 We have concluded that we should not make detailed proposals for the contents of investment contract prospectuses, summary prospectuses and confirmations, except that we make proposals in the following section as to disclosure of interest rates. Once the principle is established that these documents are necessary and that they should play a role similar to the corresponding documents used in the distribution of shares or units of mutual funds, we believe that the investment contract industry should be encouraged to participate in decisions concerning the contents of the documents. Ample precedent is provided by the requirements for prospectuses for debt instruments of other organizations; these can readily be modified for application to investment contracts. It should not be difficult to use the resultant requirements in order to produce a summary prospectus equivalent to the example for mutual funds provided in paragraph 14.59. The content of confirmations for sales of investment contracts can also be based on those used for the sale of shares or units issued by mutual funds. The administrators concerned, in collaboration with representatives of the investment contract industry, should prepare the

necessary forms of prospectus, summary prospectus and confirmation as soon as possible after publication of this report. They should also prepare guidelines for sales literature of investment contract companies similar to those proposed in paragraphs 14.67 to 14.78 for mutual funds.

18.18 Under present practice, the purchaser of an investment contract rarely sees the contract until after he has agreed to buy and has made the initial payment. We have considered whether it would be desirable to require that he be given a copy of the contract together with the summary prospectus, but have concluded against such a proposal. As noted in paragraph 17.34, the investment contract contains detailed provisions which govern every aspect of the relationship between contract-holder and company. Its early delivery to the purchaser would be of no more practical value than would be the early delivery to the mutual fund investor of the relevant corporations act or trust instrument. Instead, the summary prospectus should state that a copy of the form of contract will be provided by the salesman on request, and the salesman should be required to provide the contract when requested to do so. In addition, both the summary prospectus and the full prospectus should summarize relevant provisions of the contracts.

18.19 In Chapter XIV and elsewhere in our discussion of mutual funds we accord considerable emphasis to controls over salesmen. Such controls in our view form an essential part of a regulatory scheme applicable to the distribution of a financial instrument through a sales force. Disclosure requirements cannot provide adequate protection for an investor if the person who effects the sale to him is not prevented from engaging in unethical conduct. The controls presently applicable to salesmen of investment contract companies in most provinces are of little practical importance. Few difficulties have resulted from this since all such salesmen also sell mutual funds and are therefore subject to the controls applicable to mutual fund salesmen. However, we have concluded that a similar scheme should apply to them as to mutual fund salesmen because of the differences between the two types of investment and because of the possibility that some salesmen might not also sell mutual

funds. If the administrators of the scheme differ between investment contract companies and mutual funds, care should be taken to avoid duplications and consequent inconvenience to those affected.

18.20 A practical difficulty with the application to investment contract salesmen of requirements patterned on those proposed for mutual fund salesmen is that there is no available salesmen's training course concerning investment contracts. Such a training course would be desirable, but its preparation may not be feasible because of the comparatively small number of companies concerned. We have concluded that the administrator should be given authority, if he thinks fit, to prepare or participate in the preparation of a training course and to require that applicants take and pass the course so prepared as a precondition to their registration as investment contract salesmen. This authority could be exercised in light of experience, and if a training course was found necessary the content of the course could be shaped in recognition of the problems which dictated its adoption.

18.21 In paragraphs 14.80 to 14.88 we discuss calls on residences and "twisting" or "switching" by salesmen. We there conclude that calls on residences should be prohibited only if the administrator makes a specific order to that effect applicable to a named salesman or company. We conclude that twisting or switching should not be prohibited but that transactions which involve a duplication of sales charges should be carefully scrutinized to ensure that they involve no abuse. At the time of writing, in most provinces, salesmen who handle both investment contracts and mutual funds have a competitive advantage over those who handle only mutual funds, because there is no prohibition of calls on residences to sell investment contracts. We have concluded that the applicable requirements concerning calls on residences and twisting or switching should be uniform in the distribution of mutual funds and of investment contracts, and therefore that the conclusions reached in paragraphs 14.80 to 14.88 should be considered to be applicable to investment contracts.

18.22 Implementation of the proposals in the preceding paragraphs will result in a substantial improvement of the nature and quantity of information received by the potential purchaser of an investment contract. Those proposals would not, however, be sufficient to constitute an adequate disclosure scheme which would serve both to provide necessary information to holders of investment contracts and to stimulate the development of the effective competition at the consumer level which is so necessary if the anomalies in the present competitive structure are to be resolved. To accomplish the latter objective, the educational programme proposed in paragraphs 10.38 to 10.40 should be expanded to include investment contracts. The development of a greater degree of knowledge among investment contract purchasers concerning the implications of their proposed transactions would, we believe, have an immediate and major effect on the ability of the industry to sell contracts having the terms described in Chapter XVII.

18.23 It is also of considerable importance to an adequate disclosure scheme that continuing disclosure concerning the affairs of an investment contract company be supplied to the holders of its investment contracts. Certain contrary agruments should be considered here. Traditionally, the holder of a debt instrument does not receive the same type of continuing disclosure which is made available to the holder of an equity instrument. Once satisfied with the quality of his security he is considered not to be entitled to receive more extensive disclosure concerning corporate affairs. We have heard contentions to the effect that this distinction is relevant to investment contract companies and that investment contract-holders should not be entitled to receive continuing disclosure concerning the affairs of the company. We reject these contentions, for two reasons. The first reason reflects our agreement with the developing rejection of the theory that public holders of debt instruments should not be entitled to continuing disclosure concerning the affairs of the issuing companies. Recent amendments to corporate and securities legislation are inconsistent with that theory, and we agree with the principles underlying such amendments. It is apparent to us that any investor in a company should receive information concerning it.

18.24 The second reason for our belief that the holders of investment contracts should be provided on a continuing basis with information concerning the affairs of the issuing companies relates only to those investment contract companies which pay additional credits. Holders of the investment contracts issued by such companies look to the companies' earnings to provide the source of additional credits and therefore have an interest in disclosure greater than that of investors whose claims are completely fixed. This reason has long been accepted in the context of life insurance companies; in most jurisdictions, participating policy-holders are entitled to the same disclosure that is made to shareholders of life insurance companies. For each of these reasons, but particularly the first, we have concluded that all holders of investment contracts should be entitled to receive regular reports concerning the financial position of the issuing companies. Such reports should be distributed at least annually, and should contain financial information as extensive as that required for inclusion in the prospectus. We have concluded that the extent of protection provided for holders of investment contracts by the application of reserve requirements is such that reports need not be required on a basis more frequent than annual, although semi-annual or quarterly reports should be permitted.

18.25 Implementation of the proposals in this chapter for controls over distribution techniques and for disclosure requirements will significantly improve the quality of protection available to purchasers and potential purchasers of investment contracts. They will signal an end to the legislative philosophy that such instruments are good because they are secure, and that only minimal safeguards are needed to prevent their sale to persons who do not understand them. In its place, the resultant legislation and regulations will accept the value of competition as a step to help produce more reasoned analysis and selection among available instruments and therefore a more effective economy.

18.26 For the reasons set out in this section, we recommend:

(1) that the following recommendations should be applied to the sale of investment contracts as well as to the sale of mutual funds, with

distinctions being made between the rules applicable to instalment investment contracts and single payment contracts which correspond with the distinction between mutual fund investments made on a contractual plan and on a lump sum basis:

(a) the recommendations in paragraphs 14.61 and 14.96 concerning the delivery of prospectuses, summary prospectuses and confirmations; and

(b) the recommendations in paragraph 14.110 concerning rescission rights, except that the amount to be refunded upon the valid exercise of a right to rescind should equal the full amount paid under the contract to the time of rescission;

(2) that the necessary modifications in the form of prospectus, summary prospectus and confirmation for the use of investment contract companies should be prepared by the administrators concerned in collaboration with representatives of the investment contract industry as soon as possible after publication of this report; guidelines for sales literature of investment contract companies, similar to those proposed in paragraph 14.79, should be prepared at the same time;

(3) that no requirement should be imposed for the early delivery of a form of contract to the prospective purchaser of an investment contract, but the summary prospectus should contain a statement that the form of contract will be delivered by the salesman on request and the salesman who delivers a summary prospectus to a potential purchaser should be required to deliver a form of contract forthwith on request by the potential purchaser;

(4) that investment contract companies and their salesmen should be subject to registration requirements similar to those applied to mutual fund distribution companies and salesmen, which requirements should be used to attain similar objectives in an adequate scheme for the protection of the investor; if the administrator of these requirements

is not also responsible for the administration of corresponding requirements applicable to mutual funds, arrangements should be made between them to avoid duplication and consequent inconvenience to those affected;

(5) that the administrator should have authority to prepare, or to participate in the preparation of, a training course for investment contract salesmen and to require that it be taken and passed by applicants for registration as a condition of registration;

(6) that the recommendations concerning calls on residences and "twisting" or "switching" in paragraph 14.89 should be applied to the sale of investment contracts as well as to the sale of mutual funds;

(7) that the recommendations concerning public education in paragraph 10.48, recommendations (1) and (2) should be applied to investment contracts as well as to mutual funds; and

(8) that each investment contract company should be required to distribute to the holders of investment contracts issued by it, no less frequently than annually, a report containing financial information which corresponds to that required in the prospectus.

Disclosure of Interest Rates and Additional Credits

18.27 In Chapter XVII we make frequent references to the practices of investment contract companies in the calculation and publication of interest rates or rates of return, and of additional credits. A number of problems are noted in that discussion, and it is convenient to summarize them here:

(a) under both instalment investment contracts and single payment investment contracts, it is frequent (but not invariable) practice for sales literature to include projected results based on the assumption that additional credits will be paid at a certain rate for the life of the contract, although no promise is made to this effect;

(b) under instalment investment contracts the sales literature often does not specify an interest rate which will be earned by the invested money, but instead indicates cash surrender values which will be available at specified future dates assuming compliance with the terms of the contract and also indicates the percentages which such cash surrender values represent of total payments to the dates in question;

(c) under single payment investment contracts the sales literature often indicates an annual interest rate of return, which rate is called "simple interest" and reflects no element of interest on interest; this practice results in rates which are substantially higher than would be shown if interest were calculated in a more usual fashion;

(d) investment contracts frequently do not contain, in the contracts themselves, a statement of the promised rate of return; this is at least in part attributable to income tax considerations; and

(e) the practices for calculation of cash surrender value and additional credits are such that the rate of return may be significantly reduced as a result of a delay in payments, and that the contract-holder who withdraws between year-ends (i.e., between the dates upon which the payments for consecutive years are completed) may be penalized because he will not receive adequate credit for payments made subsequent to the preceding year-end.

18.28 The question presented by the practices noted in the preceding paragraph differs significantly from that presented by almost every other problem considered in this report. Throughout the report, the importance of disclosure is assumed and the question discussed concerning specific problems is whether they can be adequately resolved by disclosure or whether substantive controls are necessary. With one exception, we have concluded that substantive controls are not necessary to deal with the rate of return under investment contracts. The single exception, discussed in the following section, involves the rate of return earned by the holder of an instalment investment contract

who terminates early in the life of the contract. The question being considered here is, then, whether disclosure should be required. In keeping with the tenets adhered to throughout this report, we approach this question with a strong prejudice in favour of disclosure. We would have little sympathy with any contention that precise disclosure concerning the terms of a contract would be detrimental to the investment contract industry.

18.29 On the question of projected returns based on additional credits, our prejudice in favour of disclosure must be considered in light of an opposing consideration. This is that it does not seem desirable to permit the sale of debt instruments on the basis of representations of a rate of return which is not promised. The potentiality for confusion in the mind of the purchaser as a result of such representations is readily apparent. This presents the difficult question of whether disclosure should be permitted or required in spite of its potentially misleading nature.

18.30 In our view, the two principal reasons advanced for the use of additional credits militate against the use of projections based on the assumption that additional credits will be paid. It is said, first, that the practice provides the investment contract company with flexibility to reduce the rate of return to contract-holders in the event of a decrease in the rate of return earned by the company on its own invested capital. The very possibility that this contemplates is an indication to us that purchasers should not be encouraged to rely on the continued payment of additional credits. Secondly, it is said that the use of additional credits enables the company to postpone reflecting the amounts involved in its reserves until the credits are actually declared; under the second test described in paragraph 17.22, if the additional credits were promised under the contract they would have to be reflected in the determination of reserves from the outset of the contract. Since the reserve requirements are an important, even a crucial, protection for the investor this argument also leads us to question the justification for projections based on assumed rates of additional credits.

18.31 On balance, we have concluded that the use of projections based on assumed rates of additional credits should be prohibited. The prohibition should affect salesmen, sales literature, advertising and prospectuses. This does not imply that salesmen, sales literature, advertising and prospectuses should not be permitted to allude to the possibility that additional credits might be regularly declared. A prohibition of such allusions would be tantamount to a prohibition of additional credits, and we believe that they serve a valuable function in investment contracts. What is important is that the sale of the investment contract be effected on the basis of promised rather than of hoped-for returns. In the same way, the purchaser of a participating life insurance policy ordinarily makes his decision primarily on the protection and the premium rate he is promised, although the possibility of dividends is a consideration of which he is well aware.

18.32 The methods used to indicate rates of return under instalment investment contracts and under single payment investment contracts are, in our opinion, inadequate. In Chapter X we stress the desirability of uniform methods of calculation for management expenses and sales charges of mutual funds to contribute to comparability and therefore to effective competition. Uniformity is of at least equal importance in the present context, for the same reason. Yet Professor Williamson points out in the quotation in paragraph 17.47 that "simple interest" results are almost completely non-comparable. The same is true of percentage figures indicating the relationship between the cash surrender value of an instalment investment contract and the total amount paid by the holder under that contract, without reference to the time over which those payments were made. Such disclosure effectively masks the actual situation from any but the most careful analyst.

18.33 We have concluded that the prospectus and summary prospectus and all sales literature and advertisements for investment contracts should include a clear statement of the effective interest rate promised under the contract or contracts concerned. We have considered the manner in which this rate should be calculated, and have concluded that annual compounding should be permitted because of the long-term nature of most investment contracts, although

arguments can be advanced that semi-annual compounding would facilitate more effective comparisons with other financial instruments. The effective interest rate expressed in prospectuses, summary prospectuses, sales literature and advertisements should, then, be the promised rate of return expressed as an annual rate of interest with annual compounding. This figure could be supplemented by a reference to the possibility of additional credits, but the reference should clearly indicate that there is no promise to pay them and they should not be reflected in the rate expressed.

18.34 We have concluded that while the income tax position continues to be as described in paragraph 17.48, investment contract companies should not be required to include in their contracts a specification of the promised interest rate. We are fortified in this conclusion by the fact that few purchasers actually receive the contract until they have agreed to purchase, and they are therefore unlikely to be mislead by its contents. We do, however, commend to the responsible authorities a reconsideration of the income tax position described in paragraph 17.48. In our view, there are strong arguments of equity to support the application of a spreading provision such as section 35 of the Income Tax Act to the interest element included in the proceeds of any contract of this type, regardless of whether it specifies the interest rate to be paid.

18.35 We have considered the practices for computation of additional credits, and have discussed them at some length with industry representatives. We are concerned not only with the practice whereby additional credits are calculated in such a way that the rate of return of contract-holders who are tardy in payments may be reduced, but also with the practice whereby different rates of additional credits are frequently paid on different types of contracts by the same company. In effect, the investment contract companies reserve to themselves complete discretion as to how additional credits should be allocated between and among contract-holders. We requested industry representatives to consider whether this degree of discretion was desirable, and received the following comments in a letter from one company:

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As you are aware, under the present law investment contract companies have complete discretion as to the payment of additional credits, both as to amount and as to the conditions which must be met by the certificate holder in order to qualify for such credits. The practise followed by our company and which I feel is fairly standard within the industry is that the rate of additional credits paid to a particular class of certificate holders must be uniform but that the certificate holder does not qualify to receive the additional credits if his certificate is in default or on the paid up basis.

Your question then is whether it is reasonable and fair for a company to have the discretionary power to state that paid up certificates and certificates in default shall not qualify for additional credits or should a company having declared the payment of additional credits be required by statute or regulation to pay the credits to all certificate holders within a class regardless of the status of the certificate.

In our opinion any such statutory requirement or regulation would be self defeating. Obviously as long as the company is the sole arbitrator of whether or not additional credits will be paid, and I think you will agree from an economic standpoint that this decision can only be made by the company, then the company can circumvent or defeat any regulation regarding the payment of additional credits by simply not paying them. Thus the very regulation that is introduced for the purpose of helping or protecting the certificate holder can result in the long run in injuring him.

Another way to approach the problem is to look at it from the standpoint of the procedure followed by a company when declaring additional credits. Such credits are paid out of the profits of the company and consequently you start off from the standpoint of how many dollars can the company afford to pay out in additional credits in a given year. Having determined this figure you then determine who should qualify for such payment and from this information then determine the rate. Obviously the dollar amount available for distribution is fixed in any given year consequently the amount any certificate holder will receive depends solely upon the number of persons amongst whom the amount must be divided. Thus the broader the base the lower the individual benefit. You therefore resolve the problem down to the fundamental question of whether or not the certificate holder who is complying with the terms of his certificate by making his instalment payments when due is entitled to equal or preferred treatment vis-a-vis the certificate holder who is not fulfilling his duties and responsibilities under the terms of his contract. In light of the industry practise it would seem that the industry is of the opinion and it is certainly the opinion of our Company, that the certificate holder who is carrying through with his undertaking as set out in his certificate is entitled to preferential treatment in relation to the certificate holder who is in default or on the paid up basis.

Servicing accounts is one of the major expenses insofar as a certificate operation is concerned and though I have no statistics to support our contention we are nevertheless very strongly of the opinion servicing expenses are far higher on certificates that are in default than those that are not. If this opinion be correct then I think it is logical that those certificate holders who do not create additional servicing expenses should be entitled to a somewhat greater return via the additional credit route than those certificate holders who create additional expense by reason of their failure to carry out the terms of their contract.

The company attitude toward additional credits is that it is an additional encouragement to certificate holders to carry their savings program through to maturity. Your Committee has been extremely critical to date with respect to the number of certificates that are surrendered prior to maturity. We in the industry are equally concerned with the surrender rate and one of our principal methods of combating it is by the payment of additional credits to those certificate holders who meet each year's obligations when due. One would find it very difficult to reconcile the attitude of your Committee if on the one hand they subject us to severe criticism because the certificates are surrendered before maturity and on the other hand they forbid us from offering monetary inducements to certificate holders to carry their certificates to maturity.

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18.36 We do not find the arguments in the above quotation fully convincing, but we have concluded that the problems in this area are not sufficiently serious to necessitate the application of substantive controls as remedies. Instead, reliance should be placed on disclosure. The prospectus of an investment contract company should include a complete description of the procedures followed by it in the calculation of additional credits, and the summary prospectus should set out the most important parts of this description. Both documents should emphasize the reduction in rate of return which may result from any delay in payment by the contract-holder.

18.37 For the reasons set out in this section, we recommend:

(1) that the use in sales literature, in advertising, in prospectuses or summary prospectuses or by salesmen of projections based on assumed rates of additional credits under investment contracts should be prohibited; it should, however, be permissible to allude to the possibility that additional credits might be paid;

(2) that the prospectus, summary prospectus and all sales literature and advertisements for an investment contract should include a clear statement of the promised rate of return, expressed as an annual interest rate compounded annually; this figure could be supplemented by a reference to the possibility of additional credits;

(3) that while the benefits of section 35 of the Income Tax Act or any similar provision concerning tax spreading would be lost through disclosure of interest rates in the contract, such disclosure should

not be required; the present legal position should be considered by the responsible authorities; and

(4) that investment contract companies should continue to have discretion as to the allocation of additional credits, but that prospectuses for investment contracts should include complete descriptions of the procedures followed, and summary prospectuses should refer to the more important points; both should emphasize the possible reductions in rate of return which may result from delays in payments.

Rates of Return Earned by Investment Contract-Holders

18.38 In Chapter XVII we describe the terms of investment contracts, with emphasis on the rate of return earned by holders of contracts. As Tables XVII-A and XVII-B indicate, the rates of return under both instalment investment contracts and single payment investment contracts are comparatively low, judged by standards prevailing for debt instruments at the time of writing. We have, however, concluded that it would not be desirable to require an increase in the rates of return earned under investment contracts which are held to maturity. Here, as with commission rates on sales of mutual funds, the most effective and the most desirable method of control would be the operation of competition at the consumer level. Observation indicates that purchasers are becoming increasingly aware of the implications of comparative interest rates, and implementation of the disclosure requirements proposed in the two preceding sections should expedite the development of effective competition. In addition, there is a close relationship between the rates of return under investment contracts and the maximum reserve accumulation rates which administrators permit in the application of reserve requirements. An increase in such rates might, although it would not necessarily, result in an increase in promised rates of return.

18.39 While we have concluded that it would not be desirable for an increase in promised rates of return over the life of an investment contract to be required by statute, we are seriously concerned by the experience of holders of instalment investment contracts who terminate in the early stages of the

contracts. These results, described in paragraphs 17.49 to 17.55 and accompanying tables, show that many contract-holders who terminate early receive substantially less than the total amounts of their payments, thereby earning negative rates of return. The conclusion set out in the preceding paragraph relates only to the return promised to contract-holders who do not terminate prior to maturity. The difficulty is that many instalment investment contracts are not held to maturity; as note 3 to Table XVII-D indicates, as many as 62% of the instalment investment contracts sold by one company are terminated prior to maturity.

18.40 Holders of instalment investment contracts who terminate them prior to maturity suffer as a result of the necessity felt by the companies to provide their salesmen with maximum compensation as early as possible. One company, for example, pays a total commission of $242.16 to the salesman who sells an instalment investment contract with a face value of $6,200 under which monthly payments of $20 are to be made for twenty years. Of this commission, $126 is paid in the first year. The balance is paid in annual amounts of $9.68 over the following twelve years. The impact of these commission payments on the company's financial arrangements is readily apparent. The disbursement of over one-half of the first year's payment significantly reduces the amount left to accumulate over the life of the contract.

18.41 Commission arrangements which call for large proportionate payments in the first years of a contract are the principal reason for the fact that many instalment investment contracts, as exemplified by Tables XVII-A and XVII-C, provide negative rates of return if terminated in their initial years. Effective competition will, in our opinion, eventually make instalment investment contracts with such terms difficult or impossible to sell. We have concluded that the actual experience under these contracts is so unfavourable that competition cannot be relied upon to provide adequate protection for the contract-holder who terminates prior to maturity. The contention of the industry that the present arrangements are desirable because they result in forced savings is, in our opinion, contradicted by the analysis described in paragraphs 17.49 to 17.55.

18.42 There are many parallels between our conclusions concerning instalment investment contracts and those concerning mutual fund contractual plans set out in paragraphs 10.94 to 10.124. In each case, we believe that the existing situation would ultimately be corrected through the development of effective competition at the consumer level. In each case, we believe that interim substantive controls are necessary to deal with the situation until adequate competition develops. In neither case do we express any opinion on the aggregate commission received by salesmen; our criticism is of the results of the practice under which a substantial portion of the commission for a periodic payment plan is paid to the salesman during its initial period. These similarities in our analyses of the two situations do not mean that we consider them to be identical, nor that we believe similar remedies to be appropriate for them. The differences between an equity instrument and a debt instrument subject to reserve requirements are too significant to justify the assumption that similar requirements are appropriate.

18.43 The conclusion that substantive controls are necessary for the protection of the holder of an instalment investment contract who terminates early in the life of the contract leaves open the difficult question of the form which such controls should take. We have considered and decided against a proposal that all investment contract companies should be required to extend to holders of instalment investment contracts rights similar to those available under the contracts issued by Keltic Savings Corporation Limited and by Service Investments Corporation Limited, described in paragraph 17.41. Each of these companies permits the contract-holder who terminates at a time when his cash surrender value is less than the aggregate of the payments he has made to receive the latter amount, but not until the original maturity date of the contract. Our rejection of this approach is based on our belief that very serious administrative difficulties would be involved in its application, and that it would be almost impossible to establish reserve requirements for such a right.

18.44 We have concluded that the only feasible control is one under which the investment contract company would be required to pay, at the time of termination, not less than a specified percentage of the amounts previously

paid by the contract-holder. During the course of our work, one company, Savings and Investment Corporation, introduced an instalment investment contract under which the cash surrender value is never less than 50% of the amount previously paid by the holder, with accumulated interest. We held several discussions with representatives of the investment contract companies during which we reviewed the experience of holders of instalment investment contracts and expressed our concern with that experience. References to the Savings and Investment Corporation contracts were made during these discussions, and the representatives of the other companies indicated that they could continue to operate on an economic basis if required to provide greater cash surrender values. However, they have also established to our satisfaction that this would necessitate a very extensive adjustment in their methods of operation and might be prejudicial to the operations of smaller companies in particular. Balancing the interests of holders of instalment investment contracts against those of investment contract companies, we have concluded that the companies should not be permitted to pay to a terminating contract-holder less than 40% of the amount previously paid by him. Under our proposals, this 40% limit would be relevant only during the initial period of the contract's life; the integration of this restriction with reserve requirements in the manner outlined below would result in a rapid proportionate increase in cash surrender value after an initial period.

18.45 Because of the close relationship between salesman's commission and promised return to the contract-holder, and in view of our conclusion that substantive controls over the promised rate of return under a contract held to maturity are unnecessary, we have concluded that no restrictions are necessary on the total commission paid to investment contract salesmen. An undue increase in their commission level, unless financed from sources other than payments by contract-holders, would force a decrease in the promised rate of return to maturity, and adequate competition has already developed to provide assurance that such a decrease would have an adverse effect on sales. For these reasons, we do not propose any test for the reasonableness of sales charges similar to the tests proposed in Chapter X for application in the con-

text of mutual funds. The 40% requirement designed to protect the contract-holder who terminates early in the life of the contract would force commission payments to be spread through the life of the contract, but would not necessarily affect total commission payments.

18.46 A simple requirement that cash surrender value be not less than 40% of the amount paid under the contract would not be adequate, for it would leave open the possibility that the cash surrender value might be maintained for a substantial portion of the life of the contract at 40% of the amount paid to the time of termination. Average experience might be made worse rather than better if the contract-holder who terminated when the contract had almost attained maturity were to receive only 40% of the amount he had paid. To avoid this possibility, it is necessary to integrate the 40% rule with reserve requirements. Another relevant factor is that we have concluded that it is appropriate for the early redeeming contract-holder to be subject to some financial penalty, provided that his return is not thereby reduced to less than 40% of the amount he has paid under the contract. Section 28(d)(2) of the Investment Company Act of 1940 permits the deduction of not more than the lesser of 2% of the maturity value of the contract or 15% of the reserves held for the contract, whichever is less. This rule is, in our opinion, appropriate for adoption in the Canadian context.

18.47 The conclusions set out in preceding paragraphs can be implemented through the adoption of two provisions. The first would state that not less than 40% of every payment made by the holder of an instalment investment contract must be added to reserves maintained for that contract. The second would state that the cash surrender value of a contract must at all times be at least equal to the reserves held for that contract, less an amount no more than the lesser of 2% of the maturity value or 15% of the reserve, provided that the cash surrender value should in no event be less than 40% of the total of payments made under the contract. The first rule would be relevant to the determination of cash surrender value during the initial period of a contract. The second would be applicable thereafter. The contract analyzed in Table XVII-A provides an example. Its maturity value is $1,000 of which 2%

is $20. As soon as the purchaser has paid a total amount from which the deduction of $20 or 15% of the reserves then held for the contract, whichever is greater, results in a dollar amount greater than 40% of his total payments, then that dollar amount would be the required minimum cash surrender value. In cases where the contract provides for other benefits, these rules would relate only to payments allocated to the investment contract portion. The rules should be applied only to contracts issued after the effective date of the relevant legislation.

18.48 For the reasons set out in this section, we recommend:

(1) that not less than 40% of each payment made by the holder of an instalment investment contract, with respect to the investment contract benefits it provides, should be allocated to reserves for that contract;

(2) that the cash surrender value of an instalment investment contract should at no time be less than the reserves then required to be held for that contract, except that it should be permissible to deduct a surrender charge of not more than the lesser of 2% of the maturity value or 15% of the reserves, provided that the surrender charge does not reduce cash surrender value below 40% of the amount paid by the contract-holder; and

(3) that these recommendations should not apply to contracts issued prior to the effective date of the relevant legislation.

Reserve and Minimum Capital Requirements

18.49 In paragraph 17.21 we comment on the objectives served by reserve requirements. These requirements are enacted in recognition of the public interest in the ability of financial institutions which sell long-term debt instruments to the public to satisfy their obligations under the instruments as they reach maturity. A well-prepared set of reserve requirements should embody standards which would in any event be dictated by good business practice. A financial institution, like any other business which is properly

operated, should so conduct its affairs that it will be able to meet its obligations as they fall due. The relevant questions to be dealt with by reserve requirements for a financial institution are the value of the assets to be held as reserves, and the nature of the investments which should constitute those assets. These two questions are considered separately in the following paragraphs.

18.50 In paragraph 17.22 we outline the formulas embodied in existing legislation which determine the value of the assets to be held as reserves. These formulas are, in our opinion, adequate in principle but require certain modifications to provide full protection. The most important modification is in the application of the alternative formulas, referred to in paragraph 17.22 as the maturity value formula and the cash surrender value formula. As described in that paragraph, each of the formulas is presently applied on an aggregate basis to all contracts, although on some contracts the cash surrender value might be higher while on others the amount required to produce the specified maturity value might be higher. We have concluded that they should be applied on a contract-by-contract basis rather than an aggregate basis, so that in the example given in paragraph 17.22 the applicable requirement would be $405 rather than $395. The importance of this approach is accentuated by our further conclusion in paragraph 18.61 that the only minimum capital requirement which should be imposed for the maintenance of minimum capital, in excess of reserves, ought to be for the maintenance of capital of not less than a fixed dollar amount in excess of reserves. In addition, the conclusion in paragraph 18.59 that on bankruptcy or insolvency each contract-holder should be able to claim the full amount established as reserves for his contract would be unworkable if, as could easily be the case under the existing rules, the total reserves are less than would be required if the formulas were applied on a contract-by-contract rather than an aggregate basis.

18.51 The second modification we propose relates to additional credits. Those investment contract companies that pay additional credits each determine annually the rates at which additional credits will be computed during the following year. Under the formulas presently included in applicable legis-

lation, these additional credits need not be reflected in the computation of reserve requirements for a contract until a certificate year is completed under that contract and additional credits are credited to it. We have concluded that, in the application of the maturity value formula, additional credits should be reflected from the time of publication of the relevant rate. In a decision as to the value of assets required to enable the company to meet the projected liabilities on maturity, it is apparent to us that allowance should be made for additional credits the company has announced that it will declare even though they have not actually been credited to outstanding contracts.

18.52 Our only other criticism of the formulas described in paragraph 17.22 for the determination of the amount of assets to be established as reserves is that they do not deal adequately with liabilities arising under investment contracts at maturity. In any case where the contract-holder elects to receive a benefit at maturity other than the payment of cash, the company becomes subject to a continuing liability. The most frequent example is the payment of an annuity, but other arrangements are common; in many cases, the term of the certificate is simply extended for an additional period. Several companies establish reserves for such liabilities prior to maturity, and this is in our opinion a desirable procedure. It is, however, not sufficiently clear under the applicable legislation that this procedure is required. We have concluded that appropriate amendments should be made to the legislation to establish that all liabilities arising under investment contracts, whether prior to or after maturity, should be taken into account.

18.53 The exercise by the administrator of his authority to establish maximum reserve accumulation rates is of great importance in the determination of the amount of assets to be established as reserves. These rates are of considerable importance in the decisions of investment contract companies concerning the rates of return which it is feasible for them to promise to pay under investment contracts. Their establishment is one of the most important functions of the administration in the regulation of investment contract companies, and presents him with some of his most difficult decisions. On the one

hand, it is desirable to establish a low rate in order to provide certainty of the availability of adequate assets. On the other hand, it is not in the best interests of investors to establish the reserve accumulation rate at an unrealistically low level; as explained in paragraph 17.23, the result would be to force investment contract companies to promise very low rates of return on their contracts.

18.54 We have received many submissions both as to the adequacy of the present system for the establishment of maximum reserve accumulation rates and as to the merits of the rates presently in effect. We express no opinion on the latter question, except to note that the prevailing rates of interest at the time of writing are well in excess of the rates described in paragraph 17.26 and that a reconsideration of those rates may be in order. On the former question, we have concluded that the present system for the establishment of maximum reserve accumulation rates should be continued. We would oppose any statutory specification of the rate, both because adjustments should be made to reflect changes in the economy and in business practices, and because the direct imposition of responsibility on the administrator seems desirable in order to ensure that the rate will be kept under continuing review by him. In addition, special circumstances can arise in which it is appropriate to determine the reserve accumulation rate on a case-by-case basis. For example, administrators have frequently permitted the use of a comparatively high reserve accumulation rate for a single payment contract where the company shows that it has acquired an investment such as a mortgage with a corresponding yield and maturity date, and undertakes to hold that asset in satisfaction of the reserve requirement.

18.55 The submissions made to us by industry representatives have included strong contentions that they should be permitted, at least with single payment contracts, to use the rates promised under the contracts as the reserve accumulation rates for those contracts. The argument advanced in support of this contention is that the determination of the rate promised under a contract is a business decision made on the basis of the company's belief that it can earn a higher rate of return on its invested assets than that promised on its

outstanding contracts. While we recognize the significance in the determination of reserve accumulation rates of this business decision by the issuing company, we have concluded that the ultimate responsibility should remain with the administrator. Any derogation from that principle might cause serious problems, particularly in the case of an investment contract company which encountered financial difficulties and might be prepared to promise unrealistic interest rates in order to raise new money.

18.56 Our criticisms of the existing legislation governing the nature of the investments which may constitute reserves are more serious than our criticisms of the present techniques to determine the necessary amount of reserves. Ideally, these provisions should deal with permissible types of investment; their valuation; and the allocation of reserves among classes of investments. The existing legislation is, in our opinion, deficient on all three points. The precise nature of the deficiencies differs among provinces, for the provisions of the several statutes on these points are far from uniform. No Canadian statute applicable to investment contract companies deals adequately with all three points. We have concluded that more detailed provisions on all of them are needed, and that the provisions should be nationally uniform.

18.57 The problems of reserve requirements in the context of investment contract companies are very similar to those in the context of life insurance companies. Canadian life insurance legislation, that of most provinces and of the federal government, deals with all three of the points referred to in the preceding paragraph, and the administrators have accumulated much practical experience with the application of the provisions. This legislation, and the regulations applied under it, provides an excellent precedent for application in the investment contract situation. In addition, it is desirable in principle for the applicable requirements to be uniform in the two situations. We have therefore concluded that legislation applicable to investment contract companies should incorporate by reference the provisions of the Canadian and British Insurance Companies Act* concerning the nature of the investments which

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* Supra, footnote to paragraph 18.02.

may constitute reserves, the valuation of those investments, and the allocation of reserves among classes of investments. The incorporation by reference should be specified to include amendments to the relevant provisions, so that uniformity can be maintained.

18.58 A problem which has occasioned some concern among administrators is the investment of reserves in securities issued by companies associated with investment contract companies. The relevant considerations here are very similar to those considered at length in Chapter IX in the context of mutual funds. We have considered whether to propose that requirements similar to those outlined in Chapter IX should be applied to investment contract companies, and have concluded against their general application in this context. When the proposed amendments to the Canadian and British Insurance Companies Act which form the basis of a considerable portion of the scheme outlined in Chapter IX become effective, they will, under the proposals made in preceding paragraphs, apply to investment contract companies. Unless and until a determination is made by the responsible authorities that the wider set of requirements in Chapter IX should be applied to life insurance companies, we think that the desirability of uniformity in reserve requirements militates against the application of those requirements to investment contract companies.

18.59 Reserve requirements are designed for a single purpose, to require the maintenance of assets sufficient to meet investment contract liabilities as they fall due. Yet the relevant statutes contain no provision which accords to the holders of investment contracts the right to claim against the reserves in priority to other creditors of an investment contract company after its bankruptcy. It would be unfortunate if trade or other creditors were able to claim against the reserves established by an investment contract company for the holders of its outstanding contracts before the claims of such holders were satisfied in full.

18.60 We have concluded that the holders of investment contracts issued by an investment contract company should be given a statutory priority to claim against the assets which constitute the reserves, in the event of the

insolvency or bankruptcy of the company. We have also concluded that the amounts of their claims should not be affected by the surrender charge permitted under paragraph 18.46 in the case of a voluntary termination; on bankruptcy or insolvency each contract-holder should be able to claim the full reserves applicable to his contract. To implement these conclusions, each investment contract company should be required to appoint a custodian which would be entrusted with the investments forming the reserves of the company. The appointment of the custodian, and the procedures for the custody of the investments, should be substantially in accordance with the proposals made in paragraphs 8.05 to 8.23 for the custody of mutual fund assets. Upon insolvency or bankruptcy of the investment contract company, the custodian would hold the investments then constituting the reserves in trust for the holders of outstanding investment contracts. This would, of course, in no way affect the contractual claim of these holders against the company. If the amount realized on sale of the investments constituting the reserves was insufficient to pay the amount owing to contract-holders, they would be able to claim for the balance, as creditors, against the other assets of the investment contract company.

18.61 In paragraph 17.30 we note the use of minimum capital requirements under which companies must maintain a certain amount of free capital in excess of their reserves as an additional protection for the holders of contracts. All provinces with legislation governing investment contract companies require the maintenance of minimum capital of not less than a specified dollar amount; as noted in paragraph 17.31, the amounts involved are as much as $500,000. The province of Saskatchewan, as noted in paragraph 17.30, also requires that investment contract companies maintain minimum capital in an amount computed as a percentage of their liabilities. The relevant considerations as to the merits of these two types of minimum capital requirements are different. There is no consensus within the investment contract industry as to the desiraability of the Saskatchewan-type requirement, but the representatives of the industry with whom we discussed the question unanimously emphasized that the purpose of reserve requirements is to enable outstanding liabilities to be met, and that the addition of such a minimum capital requirement might constitute

an onerous obligation. We agree with this, and have concluded against any proposal for the adoption on a national basis of a minimum capital requirement akin to that in effect in Saskatchewan. We are fortified in this conclusion by our belief that implementation of our proposals concerning reserves will substantially improve the degree of protection presently available.

18.62 We have concluded that a minimum capital requirement which specifies that a company may not commence or continue operations as an investment contract company without capital of not less than a specified dollar amount in excess of reserves should be imposed on a national basis. Such a provision has two objectives: to prevent a company from commencing the sale to the public of contracts which constitute long-term liabilities unless it has adequate cash reserves, and to provide an opportunity for action if an investment contract company encounters financial difficulties, before it becomes insolvent. In our opinion, the requirement adopted nationally should be based on that presently in effect in the Province of Alberta, described in paragraph 17.31. Under this provision, the company's paid-in capital, paid-in surplus and earned surplus, or any one or more of them, must amount in the aggregate to $500,000. The administrator is given the discretion to reduce this requirement where he thinks a reduction is appropriate. Under the Alberta legislation, the administrator may not reduce the requirement below $250,000. We have concluded that this restriction on the administrator's discretion should be removed. Where consistent with investor protection, the discretion should be exercised on behalf of any investment contract company in operation at the effective date of the legislation but without the necessary $500,000 of equity in excess of its reserves.

18.63 In paragraph 17.29 we note the existence in several provinces of statutory restrictions on the investments an investment contract company may make apart from its reserves. In our opinion, such a restriction should not be imposed unless accompanied by a Saskatchewan-type minimum capital requirement. In the absence of such a requirement, the available capital in excess of reserves may be distributed as dividends. The controlling shareholders

are likely to cause such a distribution when they wish to use the money for an investment which would be prohibited under applicable restrictions with the consequences of a reduction in the value of assets available to satisfy the claim of the holders of outstanding investment contracts. For this reason, and because of our belief that principal reliance should be placed on an adequate set of reserve requirements, we have concluded that no restrictions should be placed on the investments made by an investment contract company with those assets not required to constitute reserves. This conclusion should be considered subject to that set out in paragraph 18.10, that investment contract companies should not be permitted to carry on business activities other than the issuance and distribution of investment contracts and related activities.

18.64 The conclusion reached in the preceding paragraph was opposed by one submission made to us, which commented as follows:

> ...In effect, this would mean relief from the limitations [in the Canadian and British Insurance Companies Act] on common stock and real estate and extension of the basket [clause which permits a certain percentage of assets to be invested without restriction] to some undefined extent. If the recommendation were agreed upon it would seem at a minimum, that assets and accounts in respect of the "required" and "excess" assets should be required to be kept completely separate. Otherwise, control by the companies and supervisory authorities would be difficult, if not impossible. However, such a separate grouping would seem very difficult to maintain and administer. For example, a company with increasing business would, from time to time, likely have to draw on the "excess" to satisfy the reserve requirements as a result of high initial expenses incurred in respect of new business. ...

While we recognize the possibilities noted in this quotation, they are not sufficient to dissuade us from our conclusions that investment contract companies should be permitted to invest their non-reserve assets as they think fit. The proposal in paragraph 18.60 that a custodian should be appointed for the reserves will ensure the separation of reserve assets from non-reserve assets. The necessity to draw on the latter assets in order to satisfy reserve requirements should be allowed for by the companies concerned as a matter of good business policy. Failure to make such allowance may result in default under the reserve requirements.

18.65 For the reasons set out in this section, we recommend:

(1) that the formulas presently used in Canadian legislation for the determination of the amount of investment required to be held as reserves, which are summarized in paragraph 17.22, should be retained in effect subject to the following changes:

(a) the alternative formulas, one based on the present cash surrender value of contracts and the other based on the assets required to produce their maturity value, should be applied on a contract-by-contract rather than an aggregate basis, so that each contract would be reflected in the determination at the higher of the two amounts;

(b) in the application of the formula which relates to the maturity values of the contracts, additional credits should be allowed for from the time of publication of the rate at which they are to be credited, rather than from the time when contract-holders have satisfied the conditions necessary for them to be credited to their contracts; and

(c) the legislation should be amended to require that all liabilities arising under investment contracts, whether prior to or after maturity, be taken into account in the determination of the necessary amount of reserves;

(2) that the power to determine maximum reserve accumulation rates should be retained by the administrator and that a reconsideration of the existing reserve accumulation rates may be in order in view of the high rates of interest prevailing at the time of writing;

(3) that the provisions of the Canadian and British Insurance Companies Act, as from time to time amended, relating to:

(a) permissible types of investment for reserves;

(b) valuation of investments; and

(c) allocation of reserves among classes of investments

should be incorporated by reference into legislation applicable to investment contract companies;

(4) that legislation concerning investments in associated companies similar to that proposed in Chapter IX for mutual funds should not be applied to investment contract companies, except to the extent that similar legislation is made applicable to them as a result of its incorporation by reference under recommendation (3);

(5) that in the event of the bankruptcy or insolvency of an investment contract company, each contract-holder should be entitled to claim the full amount of reserves established for his contract, without deduction of the surrender charge permitted for terminations under paragraph 18.48, recommendation (2);

(6) that each investment contract company should be required to appoint a custodian to hold the assets which constitute its reserves, such appointment and custody to be in accordance with rules substantially similar to those outlined in paragraph 8.24; on the bankruptcy or insolvency of the company the custodian should hold the reserves in trust for the holders of outstanding investment contracts, who should also be able to claim as creditors against the other assets of the company in the event that liquidation of the reserves does not produce enough money to pay the amounts owing to them under recommendation (5);

(7) that investment contract companies should not be required to have and to maintain a minimum capital in excess of their liabilities, but should be required to maintain minimum paid-in capital, paid-in surplus and earned surplus such that any one or more of them aggregate $500,000 or such lesser amount as the administrator may permit; where consistent with investor protection, the administrator should exercise his discretion in favour of investment contract companies in operation at the effective date of the legislation which do not satisfy the $500,000 requirement; and

(8) that no restrictions should be imposed on the investments an investment contract company may make with its available assets in excess of its reserves.

CHAPTER XIX

ADMINISTRATION OF THE REGULATORY SCHEME

19.01 If the regulatory scheme proposed in this report is found satisfactory by the governments concerned, they must decide how it should be implemented and, once implemented, how it should be administered. These decisions will be influenced by various considerations which do not fall within our purview, such as the allocation of responsibilities between levels of government and the relative availability of staff in different departments of a government. It is therefore impossible for us to make detailed suggestions concerning the administration of our proposals. It would, however, be unrealistic for us to ignore these questions; the frequent references throughout this report to the responsibilities of the administrator are alone sufficient to indicate the importance of the allocation of administrative responsibility to the success of the regulatory scheme. We have therefore concluded that it is desirable for us to comment in general terms on some of the more important questions to be resolved, a conclusion in which we are fortified by our awareness of the responsibilities implicit in our unusual form of organization as a committee established to report to eleven governments.

19.02 The comments in this chapter are restricted to one crucial subject, which may be stated as the problems of divided jurisdiction. That subject involves three separate topics, each of which bristles with difficulties. The first is divided jurisdiction between levels of government; the second is divided jurisdiction between branches of the same government; and the third is

divided jurisdiction between governmental agencies and self-regulatory associations established by the industries concerned. Merely to state the three topics is sufficient to indicate their complexity and importance.

19.03 At the time of writing the first of the three topics referred to in the preceding paragraph, that of divided jurisdiction between levels of government, is the basis of one of the most current and controversial aspects of the development of Canadian securities legislation. This is the possible development of a single national agency to administer securities legislation. The obvious and important political implications of such a development will be considered by the governments concerned in any decisions made. The most important unresolved questions are the scope of the authority which a national agency should possess, and whether that authority should be derived from the provincial governments, from the provincial governments and the federal government, or from the federal government alone. These questions are being actively considered by federal-provincial committees with terms of reference which permit them to be placed in the wider context of the allocation of responsibilities between the two levels of government. In the following discussion we use the term "national administrative agency" to refer to such an agency regardless of the scope of its authority and of the level or levels of government from which that authority is derived.

19.04 Our impression is that a consensus is developing in favour of the principle that a national administrative agency should be established, provided that it can effectively administer legislation and will not merely duplicate regulations which already exist. We concur with that principle. Our studies have demonstrated to us both the importance of the role played by the administrator, and the extent of the difficulties which are caused for national organizations when it is necessary for them to conform to the requirements of ten or more administrators in ten jurisdictions. We do not suggest that a national administrative agency should be established solely to administer the regulatory scheme proposed in this report for application to mutual funds and investment contracts. We do suggest that many, although not necessarily all,

aspects of that scheme could be more effectively administered by such an agency than by separate administrators in the ten provinces.

19.05 While we support the development of a national administrative agency, defined in the broad sense in which we use that term, we recognize that an agency which can effectively administer legislation on a national basis and not merely duplicate administration that already exists will probably not be developed for some time, if at all. Even when it is developed, it is unlikely to assume responsibility for all aspects of all legislation affected by this report, and will therefore leave open problems of divided jurisdiction between levels of government. We have formulated the proposals made in this report with these problems, and the problems of provincial administration, in mind. Implementation of the proposed regulatory scheme should not await the development of a national administrative agency.

19.06 The second topic related to the general problem of divided jurisdiction referred to in paragraph 19.02, that of divisions between branches of the same government, also involves considerable difficulties. This is particularly true because the definition of a mutual fund recommended in Chapter V, and other recommendations made throughout this report, cut across traditional lines which divide financial institutions and which also represent divisions between the areas of responsibility of administrative authorities. As the discussion in paragraphs 1.34 to 1.72 indicates, the securities administrators in the provinces are the officials with the most effective discretionary authority over the mutual fund industry, using that term to include only the organizations usually known as mutual funds. Investment contract companies, trust companies and life insurance companies, on the other hand, are in most provinces supervised by an official who carries the titles of Registrar of Trust Companies and Superintendent of Insurance, or equivalent titles; these officials are sometimes referred to in this chapter, for convenience, as the "trust-insurance administrators". The federal Superintendent of Insurance also has certain powers over many insurance companies and trust companies. While under The Securities Act (1966) in Ontario and statutes based on it in other

provinces the provincial securities administrators acquired some authority over trust company investment funds through the application of a prospectus filing requirement, that authority has not to the time of writing been exercised as widely as has their corresponding authority over the organizations usually known as mutual funds.

19.07 It is apparent from the nature of the present administrative arrangements described in the preceding paragraphs that a number of decisions will be required in the allocation of administrative responsibilities for the regulatory scheme we propose. As noted in paragraph 19.05, it is unlikely that these problems would be avoided by the creation of a national administrative agency, for such an agency would probably not be given responsibility for all aspects of all legislation affected by this report. The creation of such an agency would, however, be a very relevant consideration in the resolution of these problems, simplifying them in some ways and complicating them in others. For that reason, the following discussion considers separately the period prior to and the period after the creation of a national administrative agency. The former period is referred to for convenience as the "period of separate administration" and the latter as the "period of national administration".

19.08 The third topic related to divided jurisdiction referred to in paragraph 19.02, that of the division of responsibilities between governmental agencies and self-regulatory associations established by the industries concerned, is of a different nature from the first two topics. A governmental agency which supervises an industry is in a position to determine the extent to which it will permit self-regulation within that industry. The considerations relevant to this determination are almost identical regardless of the nature of the agency concerned, and therefore are not substantially affected by the development of a national administrative agency. We consider this third topic separately after the discussion of the first two topics.

The Period of Separate Administration

19.09 The discussion and comments in this section are predicated on the assumption that there will be a period of time after the implementation of this report and prior to the development of a national administrative agency,

and they relate only to that period. It is of great importance that the separate administrators concerned with the legislation during this period should endeavour to attain the maximum possible degree of co-operation among themselves. Although the recommendations made in this report are formulated with the problems of separate administration in mind, serious practical difficulties could arise for the affected industries in the absence of such co-operation. Ideally, efforts at co-operation among the administrative agencies concerned may provide the benefits of a national agency before such an agency actually exists in law.

19.10 The most important questions to be resolved during the period of separate administration will relate to the allocation of responsibilities between different branches of a government. All of the various administrative agencies referred to in paragraph 19.06, and others, have responsibility for legislation applicable to financial institutions affected by proposals made in this report. A general comment on this is appropriate here. It is inevitable that the increasing degree of overlap and competition between and among financial institutions, the importance of which is stressed throughout this report, will ultimately result in a corresponding blurring of the lines between the areas of responsibility of administrative authorities charged with their supervision. This does not lessen the seriousness of the problems which must be resolved in the implementation of our proposals, but it is important to appreciate that if these problems did not arise initially in the context here being considered, they would soon arise in some other context. Close co-operation and liaison between and among securities commissions, registrars of trust companies, superintendents of insurance and any other administrators concerned is of increasing importance; this has to some extent been recognized by re-organizations in several provinces in recent years which have brought the various bodies more closely together. Such re-organizations should be strongly encouraged; the administrative authorities should work together sufficiently closely that they will share the same philosophy in the exercise of their powers and will follow similar approaches in matters of policy.

19.11 Apart from the general comment in the preceding paragraph, it is not feasible for us to make specific proposals for the allocation of responsibilities among governmental agencies. This decision must be made by each jurisdiction concerned, with due regard for a number of considerations which may differ among jurisdictions. These include the allocation of responsibility among existing administrative agencies and their relative resources. Certain comments are, however, appropriate concerning what may be the most important single decision in this area. In every province, it will be necessary to allocate responsibilities between the securities commission and the trust-insurance administrator, or to charge one of them with complete responsibility. Allocation of complete responsibility to one or the other would result in financial institutions of a certain type being subjected to different administrators in different aspects of their operations. On the other hand, division of responsibility could result in lack of uniformity.

19.12 In the decision on allocation of responsibilities between securities commissions and trust-insurance administrators, care should be taken to recognize the fact that a number of our proposals will affect the internal operations of the organizations concerned. This is true, to greater or less degree, of all our recommendations except those concerning admission to the industries; distribution of mutual funds and investment contracts; and disclosure requirements. While it might be feasible for admission requirements, distribution controls and disclosure requirements to be enforced by an administrative agency different from that responsible for other aspects of legislation applicable to a financial institution, more problems would result from the use of separate agencies to administer legislation which governed the internal operations of a financial institution. This would, for example, be the case if the securities commissions were responsible for the mutual fund regulatory scheme as it applied to trust companies, life insurance companies or investment contract companies, all of which are subject to the trust-insurance administrators in other aspects of their operations.

19.13 Because of the problems of divided jurisdiction and subject always to any overriding consideration which may be present in a particular jurisdiction, we would suggest that separate administration of regulations which affect the internal operations of a financial institution should be avoided. To this extent we are sympathetic with the position of the Trust Companies Association of Canada, described in paragraphs 5.26 to 5.32. We do not, however, agree with that Association that no aspect of regulations applicable to trust companies should be separately administered; it would, for example, be feasible for mutual fund disclosure requirements to be applied by an administrator other than the trust-insurance administrator.

19.14 For the reasons set out in this section, we recommend:

(1) that, for purposes of the following recommendations, the term "national administrative agency" refers to a single administrative agency with authority to supervise the application of part or all of the regulatory scheme proposed in this report as it applies to financial institutions affected by it, in all provinces of Canada; the term applies to such an agency regardless of whether its authority is derived from the provincial governments, the provincial governments together with the federal government, or the federal government alone;

(2) that, for purposes of the following recommendations, the term "period of separate administration" refers to the period following the publication of this report and lasting until the development of a national administrative agency if such an agency is developed; the term "period of national administration" refers to the period after the development of any such agency;

(3) that every effort should be made to develop close relationships between and among the administrative authorities responsible for the supervision of organizations affected by this report, both within each jurisdiction and among jurisdictions; and

(4) that the decision as to responsibility for the administration of legislation implementing the recommendations made in this report as

that legislation applies to various financial institutions should be made by each jurisdiction in accordance with its administrative structure and available resources. As a suggestion rather than as a conclusion, we feel that trust companies, life insurance companies and investment contract companies should not be made subject to separate administration of legislation which affects their internal operations.

The Period of National Administration

19.15 It is even more difficult for us to make firm proposals for the allocation of administrative responsibilities during the period of national administration than during the period of separate administration. This is because of the impossibility of an accurate prediction concerning either the extent or the source of the authority of a national administrative agency. At the one extreme, it might conceivably assume complete responsibility for all financial institutions affected by our proposals, although that is very unlikely. At the other extreme, it might assume only limited responsibility in a specific area, such as the registration of persons and companies which trade in securities. Its authority could be derived from the federal government alone, from the federal government together with the provincial governments, or from the ten provincial governements acting together. It is apparent that information on these matters is necessary before specific decisions can be made on the allocation of responsibilities.

19.16 It is widely assumed that the authority of a national administrative agency would include matters which are presently the responsibility of securities commissions, rather than of Superintendents of Insurance and Registrars of Trust Companies (trust-insurance administrators). If that assumption is correct, it might seem that the considerations applicable to life insurance companies, trust companies and investment contract companies during the period of national administration are similar to those applicable during the period of separate administration, and that dual administration during either period should therefore be regarded as undesirable. This is true of life insurance companies, for the segregated fund element of individual variable

policies is inextricably intertwined with other elements that are controlled by legislation specifically applicable to life insurance companies. It is also true of investment contract companies. There is at least one important difference between the situations which might make different conclusions appropriate for trust companies, particularly since the investment fund can be more readily separated from other aspects of trust company operations than can the segregated fund from other aspects of life insurance company operations. Our sympathy with the arguments advanced by the Trust Companies Association against dual administration is based on the difficulties which would result for a nationally operating trust company if it were to be made subject to two administrative authorities in each province. If ten of those twenty authorities were to be replaced by a single national body, the situation would be very different; that would be the case if the relevant responsibilities of the provincial securities commissions were to be assumed by a national administrative agency. Such an agency would almost certainly be adequately staffed to enable due allowance to be made for problems peculiar to trust companies or to investment contract companies. If that were true, we would be much less sympathetic with an industry position that applicable regulations should be administered by the same organization in each jurisdiction concerned.

19.17 For the reasons set out in this section, we recommend:

> that the suggestions in paragraph 19.14 should be considered applicable during the period of national administration as well as during the period of separate administration, except that we would think it feasible for a national administrative agency to assume responsibility for the application of the mutual fund legislation to trust companies in spite of the continued supervision of other aspects of trust company operations by provincial Registrars of Trust Companies or equivalent officials.

The Role of Self-Regulatory Associations

19.18 The third topic referred to in paragraph 19.02, the allocation of responsibility between governmental agencies and industry associations, involves a consideration of the role of self-regulation in the securities

markets. This question is as controversial as it is important. Resolution of the controversy is not assisted by the fact that self-regulation means different things to different people. At the one extreme, it could refer to an association of industry participants, operating independently of government, which voluntarily established a code of conduct and censured or expelled members who failed to adhere to it. At the other extreme it could refer to the complete delegation by government of regulatory powers to an industry association. Few opponents of self-regulation would object to the former arrangement, provided that the code of conduct applied by the association was in the public interest. Few supporters of self-regulation would accept the latter arrangement, with the complete abdication of governmental responsibilities it would involve. Specific proposals are usually located somewhere on the spectrum between these extremes.

19.19 For purposes of the following discussion, we consider self-regulation to include any arrangement under which an industry association is looked to by a governmental agency to apply controls over its members in the public interest, in circumstances where the agency might otherwise apply such controls directly. Such an arrangement would not include the first of the two extremes described in the preceding paragraph, but would include any other position on the spectrum there referred to. Except to the extent implicit in the conditions set out below, we make no attempt to describe in more detail the nature of the self-regulatory arrangement we would think most desirable. The ideal arrangement can only be attained by experiment and by government-industry co-operation over an extended period.

19.20 In Canada, the stock exchanges, The Investment Dealers' Association of Canada and The Broker-Dealers' Association of Ontario all participate in self-regulatory activities to varying degrees. The Canadian Mutual Funds Association has assumed limited responsibilities of a self-regulatory nature, and a recently organized association called the Independent Mutual Fund Dealers Association of Canada proposes to do the same. To the time of writing no similar association has been organized by the investment contract industry,

but it is reasonable to assume that one would be quickly established if it was expected to be entrusted with self-regulatory responsibilities. Before commenting on the circumstances in which reliance should be placed on these associations in the application of the regulatory scheme, it is helpful to set out our conclusions concerning the value of self-regulation and the criteria to be satisfied by an industry association if it is to carry out self-regulatory responsibilities on a satisfactory basis.

19.21 The potential advantages of an effective system of self-regulation are readily apparent. If the members of a particular industry can effectively supervise themselves and discipline members whose behaviour is detrimental to the public interest, considerable benefits will result. The governmental agencies concerned will be able to devote their resources to other activities. The industry concerned will keep its own house in order, thereby maintaining a favourable reputation with the public and with the government. In addition, an industry association may well be able to apply disciplinary techniques more effectively than could a governmental agency. Considerations of moral standards and good business practice can often be more readily appreciated by persons who are actively engaged in a particular business than by an administrator who is less familiar with day-to-day practice and with the possible implications of various types of improper behaviour. Another advantage, particularly relevant during the period of separate administration, is that an industry association can be organized on a national basis without constitutional difficulties.

19.22 Those who criticize reliance on self-regulation do not ordinarily question the value of the advantages described in the preceding paragraph. They simply regard such advantages as unattainable. To permit the assumption of responsibilities by a self-regulatory association which does not properly exercise those responsibilities results in a mere facade of public protection that may well be more dangerous than would be no protection at all. This would be particularly true if governmental agencies relied on proper performance by the self-regulatory association, and therefore failed to exercise

similar responsibilities. These are the most important criticisms, but others are also advanced. It is said that a trade association with official powers tends to become monopolistic and anti-competitive. This, also, results in a decrease rather than an increase in the quality of public protection. Finally, if membership in the self-regulatory association is not either held by or available to all participants in the industry concerned, those who are members may receive a competitive advantage over those who are not.

19.23 We have concluded on the basis of experience in Canada and the United States that desirable results can be obtained from self-regulation, but only if a number of conditions are satisfied. No association should be entrusted with self-regulatory responsibilities unless it is genuinely representative of the industry it purports to represent. This is not only because those excluded might otherwise be put at a competitive disadvantage, but also because regulatory procedures would otherwise be less effective. The second condition is that the operations of the self-regulatory association must be actively supervised by the appropriate governmental administrative authority. Indeed, the instances in which such associations have made a major contribution to the protection of the investor have almost invariably resulted from pressure applied by the administrative authorities. The principal objective of the administrative supervision should be to verify that the responsibilities of the self-regulatory association are being properly and effectively performed in the public interest.

19.24 Two additional conditions which must be satisfied if reliance is to be placed on the proper performance by a self-regulatory association of its responsibilities are well described in the following quotation from the Report of the Ontario Royal Commission on Windfall:

> In keeping with the character of the Exchange as a public institution, all policies, and the rules adopted to ensure their implementation, must be looked upon as matters of such public concern that they are made available to the public. By this means the investor may make an intelligent and informed judgment as to whether he wishes to entrust the transaction of his business to a broker committed to carrying on business as the Exchange requires.

> The administration of the Exchange and the conduct of its business, the supervision of the manner in which the members conduct their business on the Exchange, and the initial investigations to determine if the conduct of members is in keeping with the principles governing the Exchange, are matters which should be left to the permanent staff of the Exchange free from any interference by any member. That staff must be competent to discharge the responsibility, and its independence and freedom from influence by the Governors and members must be unquestionable.*

19.25 The comments made in the above quotation are, in our opinion, as applicable to a self-regulatory association in the mutual fund or investment contract industry as they are to a stock exchange. Only two points should be noted. First, public disclosure of policies and rules should in our opinion extend to actions taken to enforce those policies and rules. Second, we would think it appropriate for the final decisions on disciplinary matters to be made by the members rather than the staff of the association if, but only if, the initial investigation was conducted by the staff and the administrator was advised of the proceedings and of the result so that he could take further action if necessary. The latter requirement should be satisfied even if the disciplinary decision was made by the staff. The fifth and final condition to the effective operation of a self-regulatory arrangement is implicit in these statements. This condition is that the self-regulatory association must, in fact, be prepared to assume and to carry out the responsibility of disciplining its members.

19.26 The other side of the coin must also be considered. The conditions enumerated in the preceding paragraphs all involve the imposition of obligations or restrictions on a self-regulatory association. It might seem reasonable for the association to demand that some form of advantage be granted to its members in order to justify the acceptance of such obligations or restrictions. The example most often pointed to is the National Association of Securities Dealers in the United States. Under section 15A of the Securities Exchange Act in that country, members of the N.A.S.D. receive a limited exemption from the anti-trust laws which permits them to operate with a fixed commission structure. We do not believe that a similar "carrot" is feasible in

* Report of the Royal Commission to Investigate Trading in the Shares of Windfall Oils and Mines Limited (Ontario, September, 1965) page 106.

the Canadian context, and experience in this country indicates that none is necessary. The C.M.F.A. like other self-regulatory associations is anxious to be entrusted with responsibilities regardless of the availability of such an inducement, on the theory that it is desirable for the industry to be involved as much as possible in the formulation and application of the regulations by which it is governed.

19.27 In view of the interest of the Canadian Mutual Funds Association in being entrusted with self-regulatory responsibilities in the administration of the regulatory scheme proposed by this report it is necessary to discuss that association in more detail. Founded in 1962, it has since carried on an active public relations service on behalf of the mutual fund industry. It compiles and distributes statistics, and maintains liaison with governmental authorities; we acknowledge in the preface to this report the value of the contribution which the C.M.F.A. has made to our work. It functions as a trade association, providing for the sharing of ideas among its members and for other activities traditional to such associations. It prepares and administers the salesman training course described in paragraphs 14.18 to 14.24. All these activities are important and would necessitate the continued existence of the C.M.F.A. regardless of its role as a self-regulatory association. To determine its adequacy for that role, it is necessary to assess whether the C.M.F.A. satisfies the five conditions enumerated in paragraphs 19.23 to 19.25.

19.28 The first of the five conditions, that the association must genuinely represent the industry it purports to represent, involves special problems with the C.M.F.A. That association represented, at December 31, 1968, 41 of the 136 mutual funds qualified for sale in Canada. The management companies of its member mutual funds included only 14 of the 92 management companies associated with mutual funds qualified for sale in Canada. On the other hand, the aggregate total net assets of its member mutual funds were about 86% of those of all Canadian-organized mutual funds then qualified for Canadian sale. This means that the association represents the great majority by dollar value, and a minority by numbers, of Canadian mutual funds.

19.29 The members of the C.M.F.A. have certain common characteristics. Every mutual fund which belongs to it is sold subject to a basic sales charge rate in excess of 8.0%. Most of these mutual funds are distributed primarily or exclusively through direct sales forces, and the distribution companies of the other mutual funds rely heavily on sales forces associated with brokerage firms and on independent sales forces; it is, then, accurate to say that every mutual fund which is a member of the C.M.F.A. is distributed primarily through sales forces. No mutual fund organized outside Canada belongs to the C.M.F.A. Until early in 1969, its membership consisted entirely of Canadian-organized mutual funds, their management and distribution companies. Early in 1969, one independent sales force was admitted to membership.

19.30 Because of the nature of its membership, the C.M.F.A. cannot be regarded as representative of the entire Canadian mutual fund industry. It does represent Canadian-organized mutual funds distributed through sales forces, with sales charges levied at basic rates in excess of 8.0%. Any decision to entrust self-regulatory responsibilities to the C.M.F.A. should recognize that its members all share these characteristics, which are not common to all mutual funds. That is confirmed by representations critical of the C.M.F.A. which have been made to us by participants in the mutual fund industry who are associated with mutual funds that do not share these characteristics. The restricted nature of its membership necessarily limits the extent to which it would be appropriate to entrust the C.M.F.A. with self-regulatory responsibilities. It is necessary to consider the extent to which it satisfies the other four conditions to effective self-regulation in order to determine whether the C.M.F.A. should be entrusted with self-regulatory responsibilities even subject to that limitation.

19.31 The second condition, active supervision by a governmental authority, is more a guide to the administrators concerned than a criterion for the judgment of a self-regulatory association and requires no comment here. We have concluded that none of the other three conditions is fully satisfied by the C.M.F.A. at the time of writing. Policies and rules are publicly avail-

able, but no information as to their enforcement is supplied to the public. The permanent staff is entrusted with extensive responsibilities in carrying out the functions described in paragraph 19.27, but has virtually no disciplinary authority. Finally, the Association has appeared to be reluctant to take disciplinary proceedings against its members. For all these reasons, we do not consider the C.M.F.A. as operated at the time of writing to be an organization which satisfies the necessary conditions for effective self-regulation.

19.32 The comments in the preceding paragraph relate to only one aspect of the activities of the C.M.F.A. The functions described in paragraph 19.27 are valuable, and the C.M.F.A. has made a significant contribution through them. Nor do we imply that the association has endeavoured to conceal improper activities on the part of its members; on the contrary, we recognize in paragraphs 1.68 to 1.71 the importance of its ethical requirements in the standards adhered to by them. Our only criticism is that the C.M.F.A. has not actively endeavoured to supervise the activities of its members, and it may be that this is more the fault of administrative authorities than of the Association. Development of an adequate self-regulatory association presents some of the features of the chicken-egg conundrum, and the conditions for effective self-regulation might eventually be satisfied if the Association were given more responsibility.

19.33 There are two areas in which the C.M.F.A. has assumed responsibilities of a self-regulatory nature. The first is the salesman training course, and the second is the inspection programme discussed in paragraphs 8.69 to 8.77. The Association has performed a valuable function in the development and administration of the training course; this provides an excellent example of co-operation between administrative authorities and an industry association, and of the way in which a national association can be used to surmount some of the problems involved in administration of a regulatory scheme at the provincial level. However, in view of the comments expressed in paragraph 19.29 we have doubts concerning the desirability of the existing arrangement under which administration and examinations are handled by the C.M.F.A. for salesmen

who are not associated with organizations represented by the C.M.F.A. It may well be that these are mechanical functions, effectively performed by the C.M.F.A. to the satisfaction of those concerned. For that reason we make no specific proposal for changes in the present procedure, but the administrators should be receptive to constructive proposals from organizations not represented by the C.M.F.A. for changes which would result in the assumption of these responsibilities by governmental authorities or other associations, at least with respect to salesmen not associated with C.M.F.A. members.

19.34 The inspection procedure discussed in paragraphs 8.69 to 8.77 was established shortly prior to the time of writing, and it is impossible to assess the impact of that programme. It is applied by the C.M.F.A. to its members, and by the appropriate administrators to non-members; provided that unfavourable reports are filed as a matter of routine with the administrator, this is a desirable arrangement. We encourage its continuance at least for an experimental period; if successful, and if the criticisms advanced in this section can be resolved, the inspection procedure might presage the development of similar arrangements in other aspects of industry operations.

19.35 The comments made in this section should not be permitted to obscure our general approval of the principle of self-regulation in the securities industry. The potential advantages summarized in paragraph 19.21 are worth striving for, and we hope that they will be available in the implementation of our proposals. The administrators concerned ought therefore to be receptive to suggestions for self-regulatory arrangements from the affected industries, and indeed ought to encourage such suggestions. The Canadian Mutual Funds Association is the most likely vehicle for self-regulation in the mutual fund industry, but the Independent Mutual Fund Dealers Association of Canada might also have a role of value to play. Development of similar associations by the investment contract industry should be encouraged.

19.36 For the reasons set out in this section, we recommend:

(1) that for purposes of the following recommendations, a "self-regulatory arrangement" includes any arrangement under which an industry associa-

tion is looked to by government to exercise controls over its members in the public interest which might otherwise be exercised by a governmental agency;

(2) that the following should be regarded as the conditions to be satisfied by a successful self-regulatory arrangement:

(a) the membership of the self-regulatory association must be such that it genuinely represents the industry it purports to represent;

(b) there must be active supervision of the self-regulatory association by the appropriate administrator;

(c) policies and rules and information as to their enforcement must be publicly available;

(d) the association must rely on a permanent staff to conduct the bulk of supervisory and disciplinary activities, with the exception of final decisions on disciplinary matters decisions on the latter by the members and should be reported to the appropriate administrators; and

(e) the association must be willing to discipline its members if necessary;

(3) that any decision to entrust self-regulatory responsibilities to the Canadian Mutual Funds Association as constituted at the time of writing should recognize that its members include only Canadian-organized mutual funds distributed through sales forces at basic sales charge rates in excess of 8.0% together with their management and distribution companies and one independent sales force;

(4) that the C.M.F.A. should not be considered to satisfy the conditions specified in clauses (c) to (e) of recommendation (2) until appropriate changes are made in its rules and procedures;

(5) that the administrators should be receptive to constructive proposals from organizations which are not members of the C.M.F.A. for alternatives to the present arrangements for administration of the Canadian

Mutual Funds Course so that, for their salesmen, it would be administered and examinations given by a governmental agency or another association;

(6) that the inspection programme referred to in paragraph 8.78 should, subject to the recommendations there made, be continued in effect on the same basis as at the time of writing, being applied by the C.M.F.A. to its members (with copies of unfavourable reports being given to the administrators) and by the administrators to non-members; and

(7) that the development of a scheme for self-regulation which satisfies the conditions described in recommendation (2) should be encouraged in the mutual fund and investment contract industries.

APPENDIX A

EMPLOYEES OF AND CONSULTANTS TO THE COMMITTEE

During the course of our study we had the help of many persons who assumed different responsibilities on our behalf. Some were with us for the duration of the study, while others for only short periods of time. In the following paragraphs we name some of the principal contributors to our work, but many others helped in various ways and we are grateful to them all.

Mr. Paul Bishop cast light on many of the statistical and similar problems confronting us, during a summer on our staff and subsequently on a consulting basis. Mr. George Cummins served in a senior research capacity but unfortunately found it necessary to leave our staff after a comparatively short period.

Miss Helena Beran, Miss Hilary Elliott, Miss Allison Hegarty, Miss Hilda Rodrigues and Mr. Donald Haire spent long hours over various periods of time as research assistants in the compilation of statistics. Miss M.L. Porter and Messrs. O. Doyle, J. Grosberg, T. Hickey, D. Magnusson, P. Mills, J. Myers, J. Sorbara and L. Waisberg each spent a summer on our staff as students-at-law; their legal memoranda were of great assistance. We are particularly appreciative of the assistance provided by Miss M.L. Porter, who undertook much of the painstaking but important work involved in the final preparation of the report.

Mrs. H. Fortin took a personal interest in the efficient operation of our office and in the preparation of documents for us. Mrs. D. Locey contributed much of the careful and time-consuming work necessary to type and retype the many drafts of the report. Miss Elisabeth Crosbie made a significant contribution to the running of our office. Mrs. G. Beacham also assumed responsibilities in the office but left us before the end of the study.

In our studies of the experience in the United States under the Investment Company Act of 1940 we were given generous assistance and co-operation by organizations in that country. Members of our staff visited the Securities and Exchange Commission on several occasions, and were provided with valuable assistance. Staff members also attended a special meeting arranged by the Investment Company Institute and meetings of that and other organizations.

An important contribution was made by Professor Louis Loss of the Harvard Law School and Mr. Milton P. Kroll, a Washington attorney, who advised us on a number of provisions of the 1940 Act, particularly those relating to self-dealing transactions. They collaborated in the preparation for us of an extensive memorandum on the latter provisions.

The late Professor G.J. Wong and Professor Peter Lusztig of the University of British Columbia prepared for us a report on relationships between mutual funds and the companies whose securities were held in their portfolio. Another report on the same topic, with emphasis on legal problems, was prepared by Professor Daniel Baum, a visiting professor at the Osgoode Hall Law School of York University.

Professors Paul Dell'Aniello and Pierre Lefrançois of the Ecole des Hautes Etudes Commerciales of the Université de Montréal prepared a comprehensive statistical analysis of mutual fund distribution practices and the characteristics of the consumer. This analysis was based in part on the results of an extensive personal interview survey of a number of present and past holders of mutual fund shares or units which was conducted by the Public Opinion Research Centre, Montreal, under the supervision of Professors Dell'Aniello and Lefrançois. Other aspects of the distribution process, particularly the form

and content of sales material given to prospective purchasers, were considered and reported on by a sub-committee composed of Mr. R.W. Knox-Leet, who acted as Chairman, and Messrs. J.T. Eyton, W.P. Miller, and D.G. Pittet.

Professors Richard Bower and J. Peter Williamson of the Amos Tuck School of Business Administration at Dartmouth University prepared a report on the performance of Canadian mutual funds. In addition, Professor Williamson participated actively in our work in connection with investment contracts after Professor Lorne Leitch of the University of Edmonton, who had been engaged in that work, was forced to terminate it through pressure of other commitments.

Mr. Graeme Fogelberg of the School of Business Administration at the University of Western Ontario prepared for us a report on financial disclosure by mutual funds, with the assistance of Mr. Desmond ffolliott. This report, and the views and suggestions of the Government Relations and Legal Affairs Committee of the Montreal Society of Financial Analysts and the helpful suggestions made by members of the industry to whom it was circulated for comments, were of great value in the preparation of Chapter XV in this report.

Advice on the economic implications of various proposals was received from Professor Albert Breton, of the London School of Economics, London, England, and Professor Edward Neufeld of the University of Toronto.

APPENDIX B

STATISTICAL INFORMATION CONCERNING THE OPERATIONS OF MUTUAL FUNDS IN CANADA, DECEMBER 31, 1961 - DECEMBER 31, 1967

To assist the Committee in its study of the operations of mutual funds in Canada, a considerable amount of statistical and other data were accumulated. Certain of the conclusions based on these data are stated in the report, and a limited amount of statistical information is also included. For the benefit of readers interested in more detailed analysis, this appendix contains statistical summaries dealing with certain important questions. Space limitations and the necessity of compliance with representations as to confidentiality given in connection with the collection of certain information have prevented the inclusion of a more complete survey of the information compiled by the Committee.

The most important source of data were replies to questionnaires distributed by the Committee to mutual funds operating in Canada. These questionnaires are discussed below. Other sources were also of considerable value. The Committee co-operated with the Toronto Stock Exchange in the arranging and financing of an Origin of Business Study which surveyed trading on that Exchange during six days of May and June, 1968. The results of this survey, together with other information provided by the Toronto Stock Exchange and the Montreal and Canadian Stock Exchanges, were of considerable value. The Committee also co-operated with the Task Force on the Structure of Canadian Industry in the compilation of information concerning the holdings of institutional investors in Canadian public companies. The Canadian Mutual Funds Association supplied helpful information from its files. Public sources of data such as the Financial Post Survey of Investment Funds, and Dominion Bureau of Statistics publications were also used.

As indicated above, the most important sources for the information included in this appendix were the replies to questionnaires distributed by the Committee to mutual funds operating in Canada. Copies of the questionnaires are not reproduced here, but a limited supply is available to interested persons from The Department of Consumer and Corporate Affairs in Ottawa. These questionnaires were replied to by the organizations concerned on a voluntary basis, and

representations were made by the Committee that the information obtained would be used only in an aggregated form except in cases where information concerning a specific organization was necessary for the Committee's report. Four separate questionnaires were distributed, although many of the questions they contained were similar or identical. The questionnaires were designed for each of the classes of mutual funds described in the following definitions:

Large Canadian Mutual Fund -

a mutual fund, incorporated or unincorporated, organized in Canada, shares or units of which were at December 31, 1967 qualified for sale to the public in one or more provinces of Canada and which at that date either (i) had total net assets in excess of $5,000,000; or (ii) together with other mutual funds managed by the same management company had total net assets in excess of $5,000,000. One mutual fund, RoyFund Ltd., was included in this category although at December 31, 1967 it had total net assets of less than $5,000,000. This category does not include trust company investment funds, as defined below. Nor does it include mutual funds which, while organized in Canada, are nevertheless included within the definition below of U.S.-based mutual funds by reason of the fact that they invest entirely in shares of a mutual fund or mutual funds organized in the United States.

Smaller Canadian Mutual Fund -

a mutual fund that satisfies the definition of a large Canadian mutual fund except that at December 31, 1967 it did not have total net assets in excess of $5,000,000 nor, together with other mutual funds managed by the same management company, did it have total net assets in excess of $5,000,000.

Trust Company Investment Fund -

an investment fund organized by a Canadian trust company, units of which were, at December 31, 1967, offered to the public in one or more provinces of Canada by that trust company, but not including a fund, units of which were so offered only in connection with registered retirement savings plans under section 79B of the Income Tax Act. While most investment funds of trust companies are unincorporated, at least one is incorporated. It was not included in the category of large Canadian mutual funds. Trust company investment funds are subdivided into

large trust company investment funds and smaller trust company investment funds; the former category includes those which, alone or together with other trust company investment funds organized and offered by the same trust company, had total net assets in excess of $5,000,000 at December 31, 1967, and the latter category includes all other trust company investment funds.

United States-Based Mutual Fund -
a mutual fund organized in the United States, shares of which were, at December 31, 1967, qualified for sale to the public in one or more provinces of Canada; or a mutual fund organized in Canada or elsewhere to invest exclusively in shares of such a mutual fund and shares or units of which were, at December 31, 1967, qualified for sale to the public in one or more provinces of Canada.

No questionnaire was distributed to mutual funds not falling within any of the categories defined above, although some statistical information with respect to such mutual funds was obtained from other sources. These mutual fund included "N.R.O. funds", organized in Canada for exclusive sale to non-residents of Canada, and mutual funds which had been qualified for sale in Canada prior to December 31, 1967 but were not so qualified at that date.

The most extensive questionnaires were those distributed to large Canadian mutual funds and to trust company investment funds. The questionnaire to trust company investment funds included a provision which exempted smaller trust company investment funds, as above defined, from replies to a number of questions.

Less extensive information was obtained from smaller Canadian mutual funds and smaller trust company investment funds because of the limited nature of their resources and because statistics relating to them would have comparatively small impact on industry statistics. Sufficient information was collected to permit an adequate comparison to be made of the trading operations and other characteristics of the smaller mutual funds with those of the larger mutual funds.

For the reasons indicated above, much of the detailed statistical information included in this appendix relates to large Canadian mutual funds and to large trust company investment funds. These organizations represented at December 31, 1967 nearly 98% of the assets held by mutual funds (excluding U.S.-based mutual funds) in the defined categories.

The questionnaire distributed to the United States-based Mutual Fund did not include questions concerning portfolio trading because their transactions are confined largely to the United States and are therefore of little direct relevance to an analysis of mutual fund portfolio trading operations in Canada. Relevant information such as sales to and redemptions by Canadians and the aggregate holdings of Canadians was obtained and is reflected in the tables which follow.

The tables contained in this appendix include notes to explain which of the defined classes of mutual funds are reflected in the information provided. Where data with respect to mutual funds not falling within the defined classes are included, the notes so specify and further indicate the types of other mutual funds concerned. The notes also explain any deficiencies known to us in the statistics. A number of mutual funds were omitted from the statistics because they failed to reply to the questionnaire, or to specific questions, were too late in supplying the information or were organized just before the end of 1967, but in no case do they reduce the total net assets of mutual funds reflected by a table below 94% of the total net assets of the mutual funds to which the table relates. The only exception is to be found in Table C-2 which incorporates information from smaller Canadian mutual funds whose total net assets aggregated approximately 71% of those of all such mutual funds.

For purposes of reference, the following table shows the aggregate dollar value of the assets held by mutual funds that fell within each of the six categories with which we are here concerned at December 31, 1961 and December 31, 1967.

NET ASSETS HELD BY CATEGORY OF MUTUAL FUNDS 1961 AND 1967 (1)		
CATEGORY OF MUTUAL FUNDS	TOTAL NET ASSETS	
	(DOLLARS IN MILLIONS)	
	Dec. 31 1961	Dec. 31 1967
Large Canadian mutual funds (2)	776	2454
Smaller Canadian mutual funds (2)	11	54
Large trust company investment funds	8	147
Smaller trust company investment funds	-	11
United States-Based mutual funds (3) (holdings by Canadians)	not known	104

Notes: (1) The data for 1961 was not always available.

(2) The total net assets of seven large Canadian mutual funds not included in this appendix were $10 million at December 31, 1961 and $60 million at December 31, 1967. Total net assets of ten smaller Canadian mutual funds not so included were $10.5 million at December 31, 1967. These figures are incorporated in the above table. Two of the large mutual funds and five of the small mutual funds did not reply to the questionnaire or did not receive it because they had been in operation for only a short period of time.

(3) It is important that this table be considered in the light of the definitions set out at the beginning of this Appendix. For example, the total holdings of Canadians in mutual funds organized in the United States may be substantially higher than those indicated, which include only holdings in those United States mutual funds qualified for sale in Canada.

TABLE-A

COMPOSITE STATEMENT OF NET ASSETS

Explanatory Note

The aggregated balance sheet items set out in Table A-1 for the period December 31, 1961 to December 31, 1967 are based on the replies of 45 large Canadian mutual funds and seven large trust company investment funds. A similar breakdown of the net assets of 26 smaller Canadian mutual funds as at December 31, 1966 and 1967 is given in Table A-2. Appropriate adjustments have been made to avoid duplication of information in the case of five large Canadian mutual funds and two smaller Canadian mutual funds which invest exclusively in shares or units of other mutual funds that fall within the same respective categories.

The table divides mutual fund assets into three major categories: net cash, fixed income securities without conversion features and common stocks (including securities convertible into common stock). "Net cash" is determined by aggregating chequing accounts, treasury bills and similar instruments, short-term Government bonds, corporate notes and callable notes, certificates of deposit, deposit receipts, non-chequing bank accounts and accounts receivable and deducting therefrom accounts payable and other liabilities. Fixed income securities are divided into non-convertible bonds and preferred stocks. No attempt was made to allocate fixed income securities on the basis of their country of issue, but they are believed to be almost exclusively Canadian. Common stocks, including non-voting participating stock issues, warrants, rights, etc., are divided into three categories: Canadian, American and other foreign. For purposes of most of the analyses in the body of the report, the "other foreign" category is lumped with American. A stock is considered to be Canadian if the issuing company is incorporated in Canada.

The mutual funds covered by Table A-1 had no assets apart from those indicated. For the first four dates in that table, December 31, 1961, June 30, 1962, December 30, 1962 and June 30, 1963 an inadequate breakdown of the value of common stocks between Canadian, American and other foreign was received from two large Canadian mutual funds. The total dollar value of their holdings in common stocks on each of the four dates has been added to the table in line 9

in an entry called "unallocated common stocks". There was a similar deficiency in the information provided by two smaller Canadian mutual funds at December 31, 1966 and 1967, so that a corresponding entry has been made in line 6 in Table A-2.

Three large Canadian mutual funds failed to allocate their fixed income securities between preferred stocks and bonds at the four dates referred to above: one of them did not make the allocation for any of the dates indicated up to and including June 30, 1965. The total of their fixed income securities is shown as "unallocated fixed income securities" in line 4 of Table A-1.

TABLE A-1

COMPOSITE STATEMENT OF NET ASSETS OF
LARGE CANADIAN MUTUAL FUNDS AND LARGE TRUST COMPANY INVESTMENT FUNDS AT SELECTED DATES 1961 TO 1967

(FIGURES IN THOUSANDS OF DOLLARS)

	Dec 31/61	June 30/62	Dec 31/62	June 30/63	Dec 31/63	June 30/64	Dec 31/64
1. Net Cash................	43,147	52,669	43,926	33,479	52,064	63,310	84,622
2. Non-convertible preferred stocks.........	36,267	38,085	42,899	50,741	54,471	60,239	62,666
3. Gov't bonds and non-convertible corporate bonds, debentures etc....	84,595	83,137	96,648	103,160	108,840	136,864	163,917
4. Unallocated fixed income securities........	2,629	3,592	4,969	4,965	1,565	2,387	1,841
5. Total of Items 2 through 4................	123,491	124,814	144,516	158,866	164,876	199,490	228,424
6. Canadian common stocks and securities convertible into Canadian common stocks............	482,422	440,635	524,730	601,446	667,575	780,187	893,464
7. American common stocks and securities convertible into American common stocks............	109,876	105,824	125,327	151,188	170,484	205,313	227,170
8. Other foreign common stocks and securities convertible into foreign common stocks....	9,951	14,288	20,485	24,786	22,120	15,189	16,651
9. Unallocated common stocks	4,698	6,442	8,699	13,097	-	-	-
10. Total of Items 6 through 9	606,947	567,189	679,241	790,517	860,179	1,000,689	1,137,285
11. Total Net Assets......... (Lines 1, 5 and 10)	773,585	744,672	867,683	982,862	1,077,119	1,263,489	1,450,331

TABLE A-1 (CONT'D.)

COMPOSITE STATEMENT OF NET ASSETS OF
LARGE CANADIAN MUTUAL FUNDS AND LARGE TRUST COMPANY INVESTMENT FUNDS AT SELECTED DATES 1961 TO 1967

(FIGURES IN THOUSANDS OF DOLLARS)

June 30/65	Dec 31/65	Mar 31/66	June 30/66	Sep 30/66	Dec 31/66	Mar 31/67	June 30/67	Sep 30/67	Dec 31/67
75,812	122,563	145,750	117,071	117,422	115,943	129,904	125,015	150,678	164,144
72,687	87,579	93,380	109,085	104,608	96,149	98,188	96,649	92,269	86,930
176,241	176,937	172,352	157,910	154,619	170,741	167,202	145,663	122,727	119,533
2,558	-	-	-	-	-	-	-	-	-
251,486	264,516	265,732	266,995	259,227	266,890	265,390	242,312	214,996	206,463
981,683	1,053,586	1,067,232	1,059,143	959,155	996,732	1,118,534	1,132,906	1,151,594	1,093,220
279,093	412,097	474,815	544,267	506,030	604,095	745,282	833,714	944,081	1,039,071
15,221	13,983	16,281	15,384	13,272	12,853	13,094	24,096	32,636	37,744
-	-	-	-	-	-	-	-	-	-
1,275,997	1,479,666	1,558,328	1,618,794	1,478,457	1,613,680	1,876,910	1,990,716	2,128,311	2,170,035
1,603,295	1,866,745	1,969,810	2,002,860	1,855,106	1,996,513	2,272,204	2,358,043	2,483,985	2,540,642

TABLE A-2

COMPOSITE STATEMENT OF NET ASSETS OF SMALLER
CANADIAN MUTUAL FUNDS AT DECEMBER 31, 1966 AND DECEMBER 31, 1967

(FIGURES IN THOUSANDS OF DOLLARS)

	DECEMBER 31, 1966	DECEMBER 31, 1967
1. Net cash	3,178	4,408
2. Non-convertible preferred stocks, government bonds and non-convertible corporate bonds, debentures, etc.	2,662	2,248
3. Canadian common stocks and securities convertible into Canadian common stocks	21,349	24,387
4. American common stocks and securities convertible into American common stocks	6,138	8,900
5. Other foreign common stocks and securities convertible into foreign common stocks	403	494
6. Unallocated common stocks	1,633	3,118
7. Total of items 3 through 6	29,523	36,899
8. Total net assets (Lines 1, 2 and 7)	35,363	43,555

TABLE-B

SALES AND REDEMPTIONS OF MUTUAL FUND SHARES

Explanatory Note

All mutual funds to which questionnaires were sent were asked to supply data concerning sales and redemptions of their shares or units on a monthly basis for 1962 and 1964 through 1967. For 1963 only the full year's total of sales and redemptions was requested. Subject to the qualifications mentioned below, Tables B-1 and B-2 summarize the total dollar values of shares or units sold and redeemed by trust company investment funds and large Canadian mutual funds. Figures for Guardian Growth Fund Ltd. were included in this analysis although they were omitted from other tables in this appendix.

The respondent mutual funds were asked to include in the dollar amounts given in their replies all monies actually received or paid by the mutual fund as a result of sales or redemptions of its shares or units. They therefore treated a transfer between mutual funds associated with the same management organization as involving a sale and a redemption respectively, even though such transfers did not result in an actual change in net assets managed by the management company. Three large Canadian mutual funds and two trust company investment funds having less than $38 million in net assets provided sales and redemption statistics on a net basis and therefore data supplied by them is excluded from Tables B-1 and B-2, but is included in Table B-3.

In order to gain comparability between periods and avoid presentation of information which would lead to an exaggerated idea of the volume of sales and redemptions, two adjustments have been made to the data supplied by the mutual funds. First, a $38.5 million redemption which was paid in securities has been deleted from the June 1965 redemption entry. This large redemption was a unique transaction and because it was satisfied by the delivery of portfolio securities, did not have any impact on the mutual fund's cash flow which is the focal point of the summary in Tables B-1 and B-2.

The second adjustment in the data is that all sales and redemptions of one large Canadian mutual fund have been excluded for reasons indicated in paragraph 13.63 of the Committee's report. The principal value of the two sections of Table B-1 and of Table B-2 is to facilitate analyses of the impact on Canadian securities markets of mutual fund transactions which are made necessary by the flow of cash resulting from sales or redemptions of shares or units. The omission of data relating to this mutual fund will not affect such analyses because its holdings are almost entirely in non-Canadian securities. However, to assist in other types of analysis aggregate information which includes its sales and redemptions as well as those of all other mutual funds covered by the tables is shown under the heading "adjusted totals".

Comparisons of the dollar value of sales and redemption and the net cash flow resulting therefrom on an annual basis for each category of mutual fund to which questionnaires were sent are set out in Table B-3. The "adjusted totals" of Tables B-1 and B-2 do not appear to reconcile with the sum of large Canadian mutual fund and trust company investment fund totals in Table B-3. To make such a reconciliation the following adjustments would be necessary to the adjusted totals in Tables B-1 and B-2:

1. Add the net sales or redemptions of the five organizations referred to above which did not provide gross sales and gross redemption data;

2. Deduct the $38.5 million special redemption made in June 1965 which, though it did not affect cash flow (Tables B-1 and B-2), was functionally a redemption so far as the size of the mutual fund in question was concerned.

TABLE B-1

TOTAL DOLLAR VALUE OF GROSS SALES AND GROSS REDEMPTION OF MUTUAL FUND SHARES OR UNITS ON A MONTHLY BASIS 1962-1967
LARGE CANADIAN MUTUAL FUNDS AND TRUST COMPANY INVESTMENT FUNDS

(FIGURES IN THOUSANDS OF DOLLARS)

	GROSS SALES						GROSS REDEMPTIONS					
	1962	1963	1964	1965	1966	1967	1962	1963	1964	1965	1966	1967
January.....	20,668	16,070*	18,644	36,902	36,964	26,140	4,586	7,262*	9,680	9,659	12,901	16,262
February ...	25,141		21,140	41,609	42,002	28,946	5,648		9,953	9,055	17,923	19,544
March	21,278		20,783	42,971	44,392	26,585	4,458		9,432	9,366	18,594	23,651
April.......	16,834		23,411	41,663	31,336	25,790	3,565		10,895	12,462	15,755	23,478
May.........	23,780		26,183	45,147	44,088	34,501	4,600		10,460	8,689	17,794	32,252
June........	15,076		26,739	47,694	32,796	34,782	3,796		11,974	12,051	15,580	31,340
July........	11,176		23,087	35,018	25,564	31,923	3,053		8,383	10,157	12,218	23,173
August......	12,998		24,880	33,815	31,393	41,169	2,998		9,421	9,952	15,274	29,489
September...	10,872		25,532	38,561	32,535	41,931	3,581		8,077	12,393	12,177	26,044
October.....	11,996		33,440	33,061	23,719	37,525	5,204		10,552	9,990	11,826	29,353
November....	15,545		36,704	41,366	33,872	51,637	4,393		8,979	14,440	12,790	31,036
December....	12,567		36,402	32,590	22,087	39,050	3,231		7,481	13,358	12,681	30,174
Total.......	197,931	192,840	316,945	470,397	400,748	419,979	49,113	87,144	115,287	131,572	175,513	315,796
Adjusted Total.......	209,941	203,136	332,418	518,889	520,649	584,144	51,670	93,036	125,146	154,955	244,484	441,029

* monthly average

TABLE B-2

EXCESS OF GROSS SALES OVER GROSS REDEMPTION OF MUTUAL FUND SHARES
OR UNITS ON A MONTHLY BASIS 1962-1967
LARGE CANADIAN MUTUAL FUNDS AND TRUST COMPANY INVESTMENT FUNDS

(FIGURES IN THOUSANDS OF DOLLARS)

	1962	1963	1964	1965	1966	1967
January	16,082	8,808*	8,964	27,243	24,063	9,878
February	19,493		11,187	32,554	24,079	9,402
March	16,820		11,351	33,605	25,798	2,934
April	13,269		12,516	29,201	15,581	2,312
May	19,180		15,723	36,458	26,294	2,249
June	11,280		14,765	35,643	17,216	3,442
July	8,123		14,704	24,861	13,346	8,750
August	10,000		15,459	23,863	16,119	11,680
September	7,291		17,455	26,168	20,358	15,887
October	6,792		22,888	23,071	11,893	8,172
November	11,152		27,725	26,926	21,082	20,601
December	9,336		28,921	19,232	9,406	8,876
Total	148,818	105,696	201,658	338,825	225,235	104,183
Adjusted Total	158,271	110,100	207,272	363,934	276,165	143,115

* monthly average

TABLE B-3

TOTAL DOLLAR VALUE OF GROSS SALES AND REDEMPTIONS OF MUTUAL FUND SHARES OR UNITS ON AN ANNUAL BASIS FOR 1962 TO 1967, BY CATEGORIES OF MUTUAL FUNDS.

(FIGURES IN MILLIONS OF DOLLARS)

CATEGORIES OF MUTUAL FUNDS	1962	1963	1964	1965	1966	1967	TOTAL
Large Canadian Mutual Funds							
Gross sales	199.8	188.5	304.0	475.3	499.8	541.8	2,209.2
Gross redemptions	50.1	89.5	116.8	179.3	225.5	416.1	1,077.3
Net cash from sales	149.7	99.0	187.2	296.0	274.3	125.7	1,131.9
Small Canadian Mutual Funds							
Gross sales	2.4	1.5	2.1	10.9	10.3	7.0	34.2
Gross redemptions	.7	.8	.6	2.8	4.1	5.1	14.1
Net cash from sales	1.7	.7	1.5	8.1	6.2	1.9	20.1
Trust Company Investment Funds							
Gross sales	11.8	20.1	34.0	50.2	33.8	47.3	197.2
Gross redemptions	1.6	3.6	8.3	14.1	19.8	22.6	70.0
Net cash from sales	10.2	16.5	25.7	36.1	14.0	24.7	127.2
U.S.-Based Mutual Funds							
Gross sales	-	1.1	4.8	8.4	22.8	55.1	92.2
Gross redemptions	-	.1	.3	.9	1.6	6.6	9.5
Net cash from sales	-	1.0	4.5	7.5	21.2	48.5	82.7
Total:							
Gross sales	214.0	211.2	344.9	544.8	566.7	651.2	2,532.8
Gross redemptions	52.4	94.0	126.0	197.1	251.0	450.4	1,170.9
Net cash from sales	161.6	117.2	218.9	347.7	315.7	200.8	1,361.9

TABLE-C

DOLLAR VALUE OF PURCHASES AND SALES OF PORTFOLIO SECURITIES

Explanatory Note

Portfolio transaction data were requested from large Canadian mutual funds and large trust company investment funds for each of the following periods:

- each month from January 1962 to July 1962
- August to December 1962
- the whole year of 1963
- each month from January 1964 to March 1964
- April 1964 to December 1964
- the whole year of 1965
- each month from January 1966 to December 1967.

The relevant mutual funds provided dollar value of purchases (gross cost) and sales (net proceeds) for five categories of securities: non-convertible bonds, non-convertible preferred stocks, Canadian, American and other foreign common stocks. The definitions of these categories are the same as those set out in the explanatory note to the Composite Statement of Net Assets (Table A). Eleven large Canadian mutual funds did not supply the necessary data and are not reflected on Table C-1. The table nevertheless incorporates information for mutual funds with over 94% of the assets of all large Canadian mutual funds and large trust company investment funds.

The aggregated data are set out on a monthly basis in Table C-1. Smaller Canadian mutual funds provided similar data but only for the 12 months, January 1967 to December 1967. Data on these funds are set out in Table C-2. Twelve smaller Canadian mutual funds are not reflected on Table C-2. The table incorporates information for mutual funds with over 70% of the assets of all smaller Canadian mutual funds. One smaller Canadian mutual fund supplied

portfolio transaction data on a quarterly basis rather than on a monthly basis as requested. This explains the unusually large figures reported in Table C-2 for March, June, September and December. The quarterly data reported by this mutual fund are set out below. All transactions of this mutual fund were in Canadian or United States common stock or securities convertible thereinto.

TRANSACTIONS OF A CANADIAN MUTUAL FUND
THAT REPORTED ON A YEARLY BASIS ONLY
DURING 1967

(THOUSANDS OF DOLLARS)

	March	June	September	December
Canadian Purchases........	222	846	693	735
Sales............	246	658	1,055	862
Net.............	(24)	188	(362)	(127)
United States Purchases...	-	-	-	-
Sales............	147	15	-	-
Net.............	(147)	(15)	-	-

TABLE C-1

GROSS COSTS AND NET PROCEEDS OF PURCHASES AND SALES OF PORTFOLIO SECURITIES FOR LARGE CANADIAN MUTUAL FUNDS AND LARGE TRUST COMPANY INVESTMENT FUNDS - 1962-1967

(FIGURES IN THOUSANDS OF DOLLARS)

Portfolio Securities By Class		Jan. 1962	Feb. 1962	Mar. 1962	Apr. 1962	May 1962	June 1962	July 1962	Aug-Dec 1962	Whole Yr. 1963
A. Cdn. common stocks and securities conv. into Cdn. common stocks	1. Purchases......	6,712	9,144	10,954	8,577	17,990	13,192	9,415	53,623	168,686
	2. Sales..........	2,792	2,178	4,404	3,717	3,204	6,062	3,869	22,843	71,994
	3. Net-Purchases.. (Sales)	3,920	6,966	6,550	4,860	14,786	7,130	5,546	30,780	96,692
B. Amer. common stocks & securities conv. into Amer. common stocks	4. Purchases......	1,743	4,880	12,407	6,887	6,638	5,851	3,193	10,590	48,874
	5. Sales..........	813	3,940	1,954	933	1,227	2,986	5,327	7,568	31,276
	6. Net-Purchases.. (Sales)	(930)	940	10,453	5,954	5,411	2,865	(2,134)	3,022	17,598
C. Other foreign common stocks & sec. conv. into other for. common stocks	7. Purchases......	499	888	2,231	596	562	2,632	2,357	2,962	6,896
	8. Sales..........	105	170	7	49	147	214	84	718	7,088
	9. Net-Purchases.. (Sales)	394	718	2,224	547	415	2,418	2,273	2,244	(192)
D. Non-convertible pref. stocks	10.Purchases......	903	82	170	1,068	540	598	246	3,229	18,433
	11.Sales..........	71	35	10	150	86	24	382	50	5,109
	12.Net-Purchases.. (Sales)	832	47	160	918	454	574	(136)	3,179	13,324
E. Gov't bonds & non-convertible bonds	13.Purchases......	17,630	4,341	6,844	5,534	8,103	3,892	4,939	38,339	59,407
	14.Sales..........	4,262	2,074	6,887	424	5,737	23,362	4,616	30,321	53,486
	15.Net-Purchases.. (Sales)	13,368	2,267	(43)	5,110	2,366	(19,470)	323	8,018	5,921

TABLE C-1 (CONT'D.)

GROSS COSTS AND NET PROCEEDS OF PURCHASES AND SALES OF PORTFOLIO SECURITIES FOR LARGE CANADIAN MUTUAL FUNDS AND LARGE TRUST COMPANY INVESTMENT FUNDS - 1962-1967

(FIGURES IN THOUSANDS OF DOLLARS)

Jan. 1964	Feb. 1964	Mar. 1964	Apr-Dec 1964	Whole Yr. 1965	Jan. 1966	Feb. 1966	Mar. 1966	Apr. 1966	May 1966	June 1966
11,353	14,140	14,853	182,386	259,641	17,924	21,884	26,445	14,106	19,182	20,458
12,621	7,231	8,560	87,365	121,857	17,654	12,547	11,748	14,467	16,434	15,017
(1,268)	6,909	6,293	95,021	137,784	270	9,337	14,697	(361)	2,748	5,441
8,062	2,869	5,823	50,278	189,189	27,851	22,361	26,856	45,457	42,253	33,406
2,891	4,469	4,758	34,732	78,811	14,355	7,543	12,129	11,566	9,798	16,570
5,171	(1,600)	1,065	15,546	110,378	13,496	14,818	14,727	33,891	32,455	16,836
194	19	272	3,122	2,586	154	79	395	261	280	39
5,123	2,298	1,152	3,587	5,012	141	409	577	4,054	118	169
(4,929)	(2,279)	(880)	(465)	(2,426)	13	(330)	(182)	(3,793)	162	(130)
1,223	1,443	875	8,131	43,121	5,540	3,267	293	12,873	855	5,093
-	13	612	3,123	6,994	231	13	560	829	926	703
1,223	1,430	263	5,008	36,127	5,309	3,254	(267)	12,044	(71)	4,390
3,179	5,279	1,842	51,376	79,853	3,505	5,449	4,438	5,027	2,388	1,943
2,059	1,378	3,244	13,659	67,858	1,841	840	9,803	4,282	4,216	8,534
1,120	3,901	(1,402)	37,717	11,995	1,664	4,609	(5,365)	745	(1,828)	(6,591)

TABLE C-1 (CONT'D.)

GROSS COSTS AND NET PROCEEDS OF PURCHASES AND SALES OF PORTFOLIO SECURITIES FOR LARGE CANADIAN MUTUAL FUNDS AND LARGE TRUST COMPANY INVESTMENT FUNDS - 1962-1967

(FIGURES IN THOUSANDS OF DOLLARS)

Portfolio Securities by Class		July 1966	Aug. 1966	Sept. 1966	Oct. 1966	Nov. 1966	Dec. 1966	Jan. 1967
A. Cdn. common stocks and securities conv. into Cdn. common stocks	1. Purchases	29,204	22,272	9,247	27,245	19,813	19,359	23,367
	2. Sales	23,900	12,234	5,403	25,133	13,500	24,098	19,926
	3. Net-Purchases... (Sales)	5,304	10,038	3,844	2,112	6,313	(4,739)	3,441
B. Amer. common stocks & securities conv. into Amer. common stocks	4. Purchases......	26,719	28,822	19,947	17,554	27,662	36,454	38,611
	5. Sales	12,073	16,430	10,297	15,541	13,396	14,381	22,958
	6. Net-Purchases... (Sales)	14,646	12,392	9,650	2,013	14,266	22,073	15,653
C. Other foreign common stocks & sec. conv. into other for. common stocks	7. Purchases......	13	20	133	123	-	35	-
	8. Sales	904	227	56	9	158	59	8
	9. Net-Purchases... (Sales)	(891)	(207)	77	114	(158)	(24)	(8)
D. Non-convertible pref. stocks	10. Purchases	2,400	-	332	246	594	250	30
	11. Sales	1,060	212	1,416	422	3,883	1,202	2,328
	12. Net-Purchases... (Sales)	1,340	(212)	(1,084)	(176)	(3,289)	(952)	(2,298)
E. Gov't bonds & non-convertible bonds	13. Purchases......	2,969	6,475	5,730	2,879	7,650	7,259	7,349
	14. Sales	1,377	8,764	9,212	5,687	13,465	3,290	10,577
	15. Net-Purchases .. (Sales)	1,592	(2,289)	(3,482)	(2,808)	(5,815)	3,969	(3,228)

TABLE C-1 (CONT'D.)

GROSS COSTS AND NET PROCEEDS OF PURCHASES AND SALES OF PORTFOLIO SECURITIES FOR LARGE CANADIAN MUTUAL FUNDS AND LARGE TRUST COMPANY INVESTMENT FUNDS - 1962-1967

(FIGURES IN THOUSANDS OF DOLLARS)

Feb. 1967	Mar. 1967	Apr. 1967	May 1967	June 1967	July 1967	Aug. 1967	Sept. 1967	Oct. 1967	Nov. 1967	Dec. 1967
10,308	10,067	16,779	16,497	13,150	11,902	8,967	16,809	14,646	16,764	10,677
7,847	7,897	8,216	18,217	30,740	13,620	19,102	30,035	22,824	15,464	14,809
2,461	2,170	8,563	(1,720)	(17,590)	(1,718)	(10,135)	(13,226)	(8,178)	1,300	(4,132)
55,797	62,054	55,641	48,816	77,506	72,149	61,278	57,740	56,335	57,135	44,892
43,149	69,326	32,862	45,567	55,448	46,707	35,365	51,217	54,915	27,945	35,344
12,648	(7,272)	22,779	3,249	22,058	25,442	25,913	6,523	1,420	29,190	9,548
1,165	1,782	668	703	10,021	580	1,380	5,979	482	1,882	1,969
121	439	52	137	124	133	-	401	100	213	61
1,044	1,343	616	566	9,897	447	1,380	5,578	382	1,669	1,908
437	381	274	13	279	227	140	596	1,433	430	63
761	589	258	721	487	11	178	1,437	208	785	387
(324)	(208)	16	(708)	(208)	216	(38)	(841)	1,225	(355)	(324)
3,039	5,878	3,267	5,024	1,975	3,475	2,220	2,536	2,741	6,933	3,495
6,954	6,275	10,319	8,626	5,674	9,802	9,756	3,962	2,202	3,396	6,456
(3,915)	(397)	(7,052)	(3,602)	(3,699)	(6,327)	(7,536)	(1,426)	539	3,537	(2,961)

TABLE C-2
GROSS COSTS AND NET PROCEEDS OF PURCHASES AND SALES OF PORTFOLIO SECURITIES FOR SMALLER CANADIAN MUTUAL FUNDS IN 1967

(FIGURES IN THOUSANDS OF DOLLARS)

Portfolio Securities by Class		Jan. 1967	Feb. 1967	Mar. 1967	Apr. 1967	May 1967	June 1967	July 1967	Aug. 1967	Sept. 1967	Oct. 1967	Nov. 1967	Dec. 1967
A. Cdn. common stocks and securities conv. into Cdn. common stocks	1 Purchases	908	805	1,069	809	882	1,721	721	766	2,158	597	549	2,305
	2 Sales	591	513	1,041	933	640	1,111	658	644	1,809	1,511	695	2,104
	3 Net-Purchases (Sales)	317	292	28	(124)	242	610	63	122	349	(914)	(146)	201
B. Amer. common stocks & securities conv. into Amer. common stocks	4 Purchases	566	929	833	530	739	782	687	623	705	540	833	414
	5 Sales	459	633	623	331	712	668	566	734	729	577	622	788
	6 Net-Purchases (Sales)	107	296	210	199	27	114	121	(111)	(24)	(37)	211	(374)
C. Other Foreign common stocks & sec. conv. into other for. common stocks	7 Purchases	11	-	-	7	18	-	-	-	-	-	-	-
	8 Sales	-	55	-	-	-	-	-	40	-	16	-	5
	9 Net-Purchases (Sales)	11	(55)	-	7	18	-	-	(40)	-	(16)	-	(5)
D. Non-convert. Pref. stocks	10 Purchases	-	-	-	-	-	-	-	-	-	-	-	-
	11 Sales	-	5	-	7	17	16	25	6	43	21	2	-
	12 Net-Purchases (Sales)	-	(5)	-	(7)	(17)	(16)	(25)	(6)	(43)	(21)	(2)	-
E. Gov't bonds & non-convert. bonds	13 Purchases	637	196	965	-	537	10	25	-	-	316	249	277
	14 Sales	519	246	1,152	328	505	25	10	16	233	214	153	223
	15 Net-Purchases (Sales	118	(50)	(187)	(328)	32	(15)	15	(16)	(233)	102	96	54

TABLE-D

AGGREGATED DAILY TRADING STATISTICS - FOUR PERIODS

Explanatory Note

Large Canadian mutual funds and large trust company investment funds supplied detailed transaction data for all trades executed in the following periods:

September 28	-	October 12, 1966
January 4	-	January 13, 1967
June 2	-	June 12, 1967
October 30	-	November 8, 1967

Smaller Canadian mutual funds supplied similar data but only for the October 30 - November 8, 1967 period; these data are not included in the table because it was desirable to maintain comparability between periods. In any case, relative to that of the large Canadian mutual funds, the trading of the smaller Canadian mutual funds was not material. Similarly, the dollar value of purchases and sales by the large trust company investment funds was not significant relative to the magnitude of transactions by large Canadian mutual funds and statistics relating to trust company investment funds were therefore excluded from Table D.

For purposes of this question a transaction was defined as "the total principal amount in the case of debt instruments, or number of shares in the case of equity securities, bought (or sold) through one broker on one day". Therefore, individual trades could not be segregated but each day's buying or selling of any security through one broker was the basis of the analysis. The data provided in Table D indicate the total dollar value of purchases and sales

and the net of these figures, separated into two categories: Canadian equities and American equities. In actuality American equities included transactions, in "other foreign" stocks but these were negligible in amount.

Each figure in the column headed "% Cdn. Eq. of 2 x T.S.E. $ Vol" (labelled column (C)) was calculated by expressing the figure in column labelled (B) as a percentage of twice the amount shown in column labelled (A). In other words the dollar value of mutual fund trading in column (B) in Canadian equities, on the date stated in the left hand side of the table, is compared with twice the amount of the dollar value of trading in industrial stocks on the Toronto Stock Exchange as shown in column (A).

TABLE-D

TRADING BY LARGE CANADIAN MUTUAL FUNDS

AND SUPPLEMENTARY INFORMATION - FOUR PERIODS

(FIGURES IN THOUSANDS OF DOLLARS)

Period and Date	Canadian Equities			American Equities		
Sept. 28-Oct. 12/66	Purchased	Sold	Net	Purchased	Sold	Net
Sept. 28/66	229	65	164	216	133	83
29/66	634	303	331	979	71	908
30/66	220	161	59	172	9	163
Oct. 3/66	374	297	77	9	2,035	(2,026)
4/66	571	57	514	395	941	(546)
5/66	612	2,081	(1,469)	1,487	105	1,382
6/66	531	1,754	(1,223)	115	423	(308)
7/66	645	2,198	(1,553)	660	494	166
11/66	576	508	68	2,206	2,020	186
12/66	428	309	119	914	914	-
Total	4,820	7,733	(2,913)	7,153	7,145	8
Jan. 4-Jan. 13/67						
Jan. 4/67	278	232	46	357	483	(126)
5/67	516	657	(141)	1,379	206	1,173
6/67	454	529	(75)	939	100	839
9/67	809	2,257	(1,448)	2,464	193	2,271
10/67	1,129	424	705	963	453	510
11/67	527	611	(84)	1,829	42	1,787
12/67	1,434	1,211	223	991	2,251	(1,260)
13/67	506	1,119	(613)	4,178	1,193	2,985
Total	5,653	7,040	(1,387)	13,100	4,921	8,179
June 2-June 12/67						
June 2/67	1,033	660	373	1,125	170	955
5/67	588	191	397	5,264	1,641	3,623
6/67	629	866	(237)	3,569	1,916	1,653
7/67	1,063	1,211	(148)	1,152	2,390	(1,238)
8/67	974	1,359	(385)	2,890	924	1,966
9/67	396	3,690	(3,294)	3,117	1,227	1,890
12/67	164	935	(771)	1,330	1,975	(645)
Total	4,847	8,912	(4,065)	18,447	10,243	8,204
Oct 30-Nov. 8/67						
Oct 30/67	100	207	(107)	3,039	12	3,027
31/67	380	342	38	701	429	272
Nov 1/67	621	1,292	(671)	3,994	3,678	316
2/67	310	526	(216)	1,043	2,700	(1,657)
3/67	674	668	6	1,589	3,197	(1,608)
6/67	522	635	(113)	572	3,561	(2,989)
7/67	313	482	(169)	336	-	336
8/67	457	1,593	(1,136)	1,994	2,436	(442)
Total	3,377	5,745	(2,368)	13,268	16,013	(2,745)

TABLE-D (CONT'D)
TRADING BY LARGE CANADIAN MUTUAL FUNDS
AND SUPPLEMENTARY INFORMATION - FOUR PERIODS

(FIGURES IN THOUSANDS OF DOLLARS)

Canadian & American Equities Purchased	Sold	Net	Change in TSE Index (Industrial)	TSE Ind. $ Vol. (A)	Mutual Fund Gross $ Vol. In Cdn. Eq. (B)	%Cdn. Eq. of 2xTSE $ Vol. (C)	Bond Quote 4½ Sept. 1 1983
445	198	247	-1.16	4,133	294	3.6	86.00
1,613	374	1,239	-1.20	4,718	937	9.9	86.25
392	170	222	- .94	4,891	381	3.9	86.25
383	2,332	(1,949)	-2.25	4,832	671	6.9	86.25
966	998	(32)	- .25	6,123	628	5.1	86.00
2,099	2,186	(87)	- .80	5,703	2,693	23.6	86.00
646	2,177	(1,531)	-1.34	5,652	2,285	20.2	86.25
1,305	2,692	(1,387)	- .14	5,369	2,843	26.5	86.25
2,782	2,528	254	1.06	6,224	1,084	8.7	86.25
1,342	1,223	119	1.64	4,888	737	7.5	86.25
11,973	14,878	(2,905)		52,533	12,553	11.9* Average (11.6)	
635	715	(80)	- .12	5,784	510	4.4	86.75
1,895	863	1,032	1.41	7,134	1,173	8.2	86.75
1,393	629	764	.86	7,073	983	6.9	87.00
3,273	2,450	823	1.16	7,564	3,066	20.3	86.50
2,092	877	1,215	.59	8,791	1,553	8.8	86.25
2,356	653	1,703	1.37	9,997	1,138	5.7	87.12
2,425	3,462	(1,037)	2.10	12,106	2,645	10.9	87.00
4,684	2,312	2,372	1.00	10,282	1,625	7.9	87.00
18,753	11,961	6,792		68,731	12,693	9.2* Average (9.1)	
2,158	830	1,328	.57	5,845	1,693	14.5	86.75
5,852	1,832	4,020	-1.48	8,474	779	4.6	86.00
4,198	2,782	1,416	2.74	10,808	1,495	6.9	86.25
2,215	3,601	(1,386)	.99	11,615	2,274	9.8	86.50
3,864	2,283	1,581	- .23	8,377	2,333	13.9	86.25
3,513	4,917	(1,404)	.82	7,656	4,086	26.7	85.75
1,494	2,910	(1,416)	.77	7,699	1,099	7.1	85.50
23,294	19,155	4,139		60,474	13,759	11.4* Average (11.9)	
3,139	219	2,920	- .66	7,244	307	2.1	80.00
1,081	771	310	-2.17	10,441	722	3.5	80.00
4,615	4,970	(355)	- .95	12,152	1,913	7.9	80.75
1,353	3,226	(1,873)	.68	11,956	836	3.5	80.50
2,263	3,865	(1,602)	1.70	11,813	1,342	5.7	80.00
1,094	4,196	(3,102)	.05	12,175	1,157	4.8	79.50
649	482	167	2.18	8,895	795	4.5	79.50
2,451	4,029	(1,578)	.68	13,016	2,050	7.9	79.75
16,645	21,758	(5,113)		87,692	9,122	5.2* Average (5.0)	

* Represents total of Canadian equities purchased and sold as percentage of two times the Toronto Stock Exchange dollar volume.

TABLE-E

MUTUAL FUND HOLDING AND TRADING OF 19 SELECTED STOCKS

Explanatory Note

Large Canadian mutual funds and large trust company investment funds supplied data relating to all "transactions" in 19 Canadian stocks for six years from 1962-1967. A "transaction" in a security was defined as the number of shares bought or sold through one broker in one day.

The stocks which were studied were:

(i) Alcan Aluminium Limited
(ii) Canadian Breweries Limited
(iii) Denison Mines Limited
(iv) Dominion Foundries and Steel, Limited
(v) Dominion Textiles Company Limited
(vi) Home Oil Company Limited "A"
(vii) Industrial Acceptance Corporation Limited
(viii) M. Loeb Limited
(ix) MacMillan Bloedel Limited
(x) Moore Corporation, Limited
(xi) Noranda Mines Limited
(xii) The Oshawa Wholesale Limited "A"
(xiii) The Royal Bank of Canada
(xiv) Simpsons, Limited
(xv) Steinberg's Limited "A"
(xvi) The Steel Company of Canada Limited
(xvii) Union Gas Company of Canada, Limited
(xviii) Velcro Industries Limited
(xix) Westcoast Transmission Company Limited.

These transaction data are aggregated on an annual basis and, along with other pertinent information relating to the trading of or holding by mutual funds in these stocks, are summarized out in Tables E-1 to E-6. The headings of the columns of these tables and the sources of the information used are described below.

Data in columns 1 and 14 are drawn from the year-end statistics published in the Toronto Stock Exchange Review for January of each year. With respect to number of shares outstanding at each year-end (column 1), footnotes to the tables indicate the date and basis of any share splits or consolidations which have taken place. Columns 2 and 3 report data collected by the late Professor Leslie Wong and Professor Peter Lusztig in a study of the holdings of voting stocks by various financial institutions for the years 1962 to 1966. Column 2 includes as "mutual funds" all large and smaller Canadian mutual funds and large and smaller trust company investment funds as well as a few mutual

fund organizations having net assets of about $45 million at the end of 1967 which were excluded from the other aspects of the Committee's study because they were not offering shares to the public at December 31, 1967. "All institutions" in column 3 includes the holdings of life and casualty insurance companies, private non-insured pension funds, equity-based funds managed by insurance companies, non-resident owned mutual funds, closed-end investment companies and, in 1966 only, the holdings of estate, trust and agency accounts of certain trust companies. Because of this last item, it is important to note that the 1966 "all institutions" figure is not comparable with that of preceding years. Two additional explanations relating to columns 2 and 3 are necessary. First, since the Wong - Lusztig study only provided data for 1962-1966, it was necessary to use a different source, "The Financial Post Survey of Investment Funds 1968", for columns 2 and 3 for 1967. The Financial Post statistics were adjusted to use the same definition of mutual fund as that used for purposes of the Wong - Lusztig study but it was not possible to obtain parallel data for "all institutions". Consequently the series in column 3 for 1967 is not comparable to preceding years. Second, the Wong - Lusztig study only dealt with voting stocks, thus it did not provide data on Home Oil"A", Oshawa Wholesale"A", and Steinberg's"A". Information on holdings of these companies by mutual funds and other institutions is drawn entirely from the Financial Post investment fund surveys for 1963 to 1968.

Column 6 sets out total trading volume on all exchanges. The source of these data is a series developed by the statistical department of the Toronto Stock Exchange. It includes reported trading on all North American stock exchanges.

The replies to the Committee's questionnaires received from large Canadian funds and large trust company investment funds were the primary sources of statistics on mutual fund share trading. The figures in column 8 are the sum of purchases and sales by all such mutual funds. It should be noted that the number of mutual funds upon which the Wong - Lusztig study reported, in column 2, is slightly greater than the number which responded to the Committee's questionnaire. However, because of the small size of the mutual funds not included in the questionnaire responses, the effect of the different basis is

negligible. Column 9 relates column 8 and column 6 so that the percentage in column 9 is equal to the figure in column 8 divided by two times that in column 6. As stated in the note to Table D, the reason for doubling the number in column 6 in relating it to the sum of shares purchased and sold by mutual funds (column 8) is to recognize that for every share traded, there is one bought and one sold.

In column 10 trading by mutual funds as a percentage of mutual fund holdings is calculated by dividing the figure in column 8 by the average number of shares held by mutual funds during the year. This average is the mean of the number of shares held at the end of the year in question and the number held at the end of the preceding year. Because 1961 data were not available, no average number of shares held by mutual funds could be calculated for 1962; thus column 10 for 1962 is based on the year-end holdings of mutual funds.

The price to earnings ratio set out in column 11 is taken from the Financial Post data cards. Columns 12 and 13 are computed for 1962 and 1967 only. The numbers were calculated by counting the number of applicable mutual funds included in the tabulation of column 2.

TABLE E-1

HOLDING AND TRADING OF 19 SELECTED STOCKS BY LARGE CANADIAN MUTUAL FUNDS AND LARGE TRUST COMPANY INVESTMENT FUNDS IN 1962

Selected Stocks Held and Traded	1	2	3	4	5	6
	Number of shares o/s at year-end	Number of shares held by mutual funds	Number of shares held by all inst.	Shares held by mut. funds as % of shares o/s	Shares held by all inst. as % of shares o/s	Total shares traded all exchanges
	(000's)	(000's)	(000's)	%	%	(000's)
Alcan Aluminium..................	30,724	410	1,191	1.3	3.9	1,484
Canadian Breweries (1)...........	21,762	874	2,139	4.0	9.8	2,826
Denison Mines	4,475	-	10	-	0.2	606
Dominion Foundries	3,808	274	656	7.2	17.2	358
Dominion Textiles	2,581	196	679	7.6	26.3	495
Home Oil "A"	2,055	97	n.a.	4.7	n.a.	599
Industrial Acceptance............	5,855	662	1,298	11.3	22.2	1,178
M. Loeb..........................	797	102	109	12.8	13.7	317
MacMillan Bloedel................	20,826	860	1,779	4.1	8.5	1,848
Moore Corporation................	6,684	254	938	3.8	14.0	585
Noranda Mines (2)................	9,282	450	899	4.9	9.7	886
Oshawa Wholesale "A".............	491	22	n.a	4.5	n.a	140
Royal Bank of Canada.............	6,653	236	798	3.5	12.0	567
Simpsons.........................	3,431	83	796	2.4	23.2	298
Steinberg's "A"..................	1,335	51	n.a	3.8	n.a	84
Stelco (3).......................	20,246	888	2,965	4.4	14.7	1,744
Union Gas Company................	4,531	554	1,195	12.2	26.4	382
Velcro Industries................	156	-	n.a.	-	n.a.	n.a.
Westcoast Transmission...........	6,208	39	218	0.6	3.5	322

NOTES: (1) Split 5 - 1 on March 9th; (3) Split 4 - 1 on May 4th; - = zero
(2) Split 2 - 1 on June 2nd; n.a. = information was not available;

TABLE E -1 (CONT'D)

HOLDING AND TRADING OF 19 SELECTED STOCKS BY LARGE CANADIAN MUTUAL FUNDS AND LARGE TRUST COMPANY INVESTMENT FUNDS IN 1962

7	8	9	10	11	12	13	14
Shares held by mutual funds as % of trading	Trading by mut. funds (gross)	Trading by mut. funds as % of 2X total trad.	Trading by mut. funds as % of holding	Price to earnings ratio	Number of funds holding any shares of company	more than 5% of m.f. holdings	Year-end price of selected stocks $
%	(000's)	%	%				
27.6	107	3.6	25.9	20	29	7	21 3/4
30.9	703	12.4	80.4	15	18	5	10 7/8
-	1	0.8	-	5	-	-	10 5/8
76.4	19	2.7	7.0	13	25	6	61 1/4
39.5	42	4.3	21.5	10	10	3	16 5/8
16.1	50	4.2	51.8	47	5	5	11 3/8
56.1	86	3.7	13.0	15	23	4	27
32.2	102	16.1	100.0	18	1	2	17
46.6	245	6.6	28.5	11	26	5	18 3/4
13.4	52	4.5	20.5	23	16	5	46 3/4
50.8	47	2.6	10.4	16	23	5	33 5/8
15.3	22	7.7	100.0	17	1	1	30 1/8
41.5	80	7.0	33.9	23	24	4	76 1/2
27.9	8	1.3	9.6	18	14	4	29 7/8
61.1	12	7.0	23.0	16	4	4	19
51.0	31	0.9	3.2	12	24	5	18 5/8
144.9	84	11.0	15.2	25	24	3	18 1/2
-	-	n.a.	-	n.a.	-	-	8 1/2
12.0	2	0.3	5.2	53	3	2	13 7/8

TABLE E-2
HOLDING AND TRADING OF 19 SELECTED STOCKS BY LARGE CANADIAN MUTUAL FUNDS AND LARGE TRUST COMPANY INVESTMENT FUNDS IN 1963

	1	2	3	4	5	6
Selected Stocks Held and Traded	Number of shares o/s at year-end (000's)	Number of shares held by mut. funds (000's)	Number of shares held by all inst. (000's)	Shares held by mut. funds as % of shares o/s %	Shares held by all inst. as % of shares o/s %	Total shares traded all exchanges (000's)
Alcan Aluminium................	31,024	601	1,458	1.9	4.7	2,200
Canadian Breweries.............	21,762	819	4,299	3.8	19.8	2,447
Denison Mines..................	4,475	3	3	0.1	0.1	636
Dominion Foundries.............	3,828	282	690	7.4	18.0	299
Dominion Textiles..............	2,580	318	634	12.3	24.6	527
Home Oil "A"	2,498	111	n.a.	4.4	n.a.	616
Industrial Acceptance..........	5,897	639	1,165	10.8	19.8	1,175
M. Loeb........................	809	118	130	14.6	16.0	135
MacMillan Bloedel..............	20,846	909	1,800	4.4	8.6	1,807
Moore Corporation..............	6,706	307	1,001	4.6	14.9	593
Noranda Mines..................	9,963	466	890	4.7	8.9	935
Oshawa Wholesale "A"...........	504	49	n.a.	9.8	-	78
Royal Bank of Canada...........	6,653	272	793	4.1	11.9	482
Simpsons.......................	3,431	119	836	3.5	24.4	304
Steinberg's "A" (1)	1,681	117	n.a.	6.9	n.a.	169
Stelco.........................	20,378	1,005	2,926	4.9	14.4	2,231
Union Gas Company..............	4,531	600	1,148	13.3	25.3	508
Velcro Industries..............	156	-	n.a.	-	n.a.	n.a.
Westcoast Transmission.........	6,425	60	129	0.9	2.0	385

NOTES:
(1) 6,825 shares issued for cash. 408,000 converted preferred shares 1962-63
n.a. = Information was not available
- = Zero

TABLE E-2 (CONT'D.)
HOLDING AND TRADING OF 19 SELECTED STOCKS BY LARGE CANADIAN MUTUAL FUNDS AND LARGE TRUST COMPANY INVESTMENT FUNDS IN 1963

7	8	9	10	11	12	13	14
Shares held by mut. funds as % of trading %	Trading by mut. funds (gross) (000's)	Trading by mut. funds as % of 2X total trad. %	Trading by mut. funds as % of holding %	Price to earnings ratio	No. of funds any shares of company	holding more than 5% of m.f. holdings	Year-end price of selected stocks $
27.3	183	4.2	36.2	26			27 1/8
33.5	51	1.0	6.0	15			9 3/4
0.5	3	0.2	200.0	5			9.95
94.4	20	3.3	7.2	13			63 3/4
60.3	101	9.6	39.5	11			23 5/8
18.1	1	0.1	1.0	18			12 1/4
54.4	37	1.6	5.6	14			24
87.5	11	4.0	9.9	14			23
50.3	209	5.8	23.6	13			26 5/8
51.8	61	5.1	21.7	23			50
49.8	36	1.9	7.8	17			41 1/4
63.1	31	19.9	87.3	18			43 1/2
56.4	40	4.2	15.9	22			74 3/4
39.1	37	6.1	36.6	19			37 5/8
69.0	71	20.9	84.0	14			25 1/8
45.1	134	3.0	14.2	12			23 5/8
118.3	57	5.6	9.9	22			22 1/2
n.a	-	-	-	n.a.			19 1/2
15.6	26	3.4	52.5	39			16 1/2

TABLE E-3

HOLDING AND TRADING OF 19 SELECTED STOCKS BY LARGE CANADIAN MUTUAL FUNDS AND LARGE TRUST COMPANY INVESTMENT FUNDS IN 1964

	1	2	3	4	5	6
Selected Stocks Held and Traded	Number of shares o/s at year-end (000's)	Number of shares held by mut. funds (000's)	Number of shares held by all inst. (000's)	Shares held by mut. funds as % of shares o/s %	Shares held by all inst. as % of shares o/s %	Total shares traded all exchanges (000's)
Alcan Aluminium..................	31,051	869	1,914	2.8	6.2	2,935
Canadian Breweries.............	21,762	758	4,173	3.5	19.2	3,466
Denison Mines..................	4,475	-	5	-	0.1	1,345
Dominion Foundries (1)...........	15,362	1,147	2,692	7.5	17.5	905
Dominion Textiles..............	2,583	296	520	11.5	20.1	481
Home Oil "A"	2,601	121	n.a.	4.7	n.a.	1,557
Industrial Acceptance..........	5,897	559	1,150	9.5	19.5	1,353
M. Loeb (2)..........................	2,507	289	398	11.5	15.9	823
MacMillan Bloedel..............	20,846	1,026	2,106	4.9	10.1	1,798
Moore Corporation..............	7,038	389	1,124	5.5	16.0	501
Noranda Mines (5).................	11,704	667	1,201	5.7	10.3	960
Oshawa Wholesale "A" (3).........	1,024	161	n.a.	15.7	n.a.	65
Royal Bank of Canada...........	6,653	280	969	4.2	14.6	477
Simpsons (4)......................	6,914	238	1,597	3.5	23.1	308
Steinberg's "A"................	1,768	359	n.a	20.3	n.a	480
Stelco (6).........................	24,139	1,078	3,253	4.5	13.5	3,175
Union Gas Company (7).............	4,985	684	1,266	13.7	25.4	566
Velcro Industries..............	166	-	n.a.	-	n.a.	n.a.
Westcoast Transmission	6,425	74	125	1.2	1.9	948

NOTES:

(1) Split 4 - 1, May 2nd

(2) Split 3 - 1, May 30th

(3) Split 2 - 1, June 9th

(4) Split 2 - 1, May 16th

(5) Dec. 15th 1964 takeover of Geco Mines Ltd. 1,531,754 Noranda shares issued to Geco stockholders

(6) Oct. 15th 1964 takeover of Page-Hersey Tubes, Ltd. 3,761,457 Stelco shares issued to Page-Hersey Stockholders

(7) Rights issue resulting in 453,180 additional common shares. Rights expires July 17th 1964.

n.a. = Information was not available

\- = Zero

TABLE E-3 (CONT'D.)

HOLDING AND TRADING OF 19 SELECTED STOCKS BY LARGE CANADIAN MUTUAL FUNDS AND LARGE TRUST COMPANY INVESTMENT FUNDS IN 1964

7	8	9	10	11	12	13	14
					Number of funds holding		
Shares held by mut. funds as % of trading %	Trading by mut. funds (gross) (000's)	Trading by mut. funds as % of 2X total trad. %	Trading by mut. funds as % of holding %	Price to earnings ratio	any shares of company	more than 5% of m.f. holdings	Year-end price of selected stocks $
29.6	390	6.6	53.1	20			31
21.9	288	4.2	36.5	16			10 5/8
-	2	0.1	133.3	10			21 3/4
126.8	36	2.0	5.0	14			23 1/2
61.5	142	14.7	46.2	12			33 1/4
7.8	46	1.5	39.9	17			18
41.3	181	6.7	30.2	13			25 7/8
35.2	152	9.3	74.7	16			11
57.1	179	5.0	18.5	16			34 1/8
77.6	74	7.4	21.3	21			60
69.5	89	4.6	15.7	17			51 1/4
247.7	39	29.8	37.1	21			34
58.8	11	1.2	4.0	21			79
77.3	28	4.5	15.7	24			28 5/8
74.9	258	26.9	108.5	18			37 1/4
33.9	174	2.7	16.7	13			27
120.9	75	6.6	11.6	24			26 1/8
-	-	-	-	n.a.			35
7.9	17	0.9	25.4	35			15 3/8

TABLE E-4

HOLDING AND TRADING OF 19 SELECTED STOCKS BY LARGE CANADIAN MUTUAL FUNDS AND LARGE TRUST COMPANY INVESTMENT FUNDS IN 1965

	1	2	3	4	5	6
Selected Stocks Held and Traded	Number of shares o/s at year-end (000's)	Number of shares held by mut. funds (000's)	Number of shares held by all inst. (000's)	Shares held by mut. funds as % of shares o/s %	Shares held by all inst. as % of shares o/s %	Total shares traded all exchanges (000's)
Alcan Aluminium................	31,087	871	1,937	2.8	6.2	2,661
Canadian Breweries.............	21,762	635	3,952	2.9	18.2	4,303
Denison Mines..................	4,475	151	283	3.4	6.3	2,131
Dominion Foundries.............	15,372	1,191	2,981	7.8	19.4	1,178
Dominion Textiles..............	2,583	345	646	13.4	25.0	477
Home Oil "A"...................	2,610	165	n.a.	6.3	n.a.	906
Industrial Acceptance..........	5,897	712	1,374	12.1	23.3	914
M. Loeb........................	2,548	485	615	19.0	24.1	959
MacMillan Bloedel..............	20,856	1,074	2,157	5.2	10.3	1,570
Moore Corporation..............	7,070	498	1,327	7.1	18.8	621
Noranda Mines..................	11,837	626	1,273	5.3	10.8	1,349
Oshawa Wholesale "A" (1)	2,243	361	n.a.	16.1	n.a.	211
Royal Bank of Canada...........	6,652	278	853	4.2	12.8	453
Simpsons.......................	7,003	219	1,686	3.1	24.1	663
Steinberg's "A"................	1,800	430	n.a	23.9	n.a	218
Stelco.........................	24,139	1,389	3,892	5.8	16.1	2,950
Union Gas Company..............	4,985	677	1,414	13.6	28.4	412
Velcro Industries..............	170	(2)	n.a.	0.2	n.a.	n.a
Westcoast Transmission.........	6,658	131	233	2.0	3.5	1,305

NOTES:
(1) Split 2 - 1, Oct. 21st
(2) Less than 1,000 (Shares held 250; traded 250)
n.a. = Information was not available
\- = Zero

TABLE E-4 (CONT'D.)
HOLDING AND TRADING OF 19 SELECTED STOCKS BY LARGE CANADIAN MUTUAL FUNDS AND LARGE TRUST COMPANY INVESTMENT FUNDS IN 1965

7	8	9	10	11	12	13	14
Shares held by mut. funds as % of trading %	Trading by mut. funds (gross) (000's)	Trading by mut. funds as % of 2X total trad. %	Trading by mut. funds as % of holding %	Price to earnings ratio	Number of funds holding any shares of company	Number of funds holding more than 5% of m.f. holdings	Year-end price of selected stocks $
32.7	243	4.6	27.9	16			33 1/4
14.8	80	0.9	11.5	23			7 3/4
7.1	133	3.1	176.2	12			36
101.1	217	9.2	18.6	17			27 1/4
72.4	71	7.5	22.3	16			32 1/2
18.2	44	2.4	30.5	17			18
78.0	182	10.0	28.6	12			23 1/8
50.6	223	11.6	57.6	21			15 7/8
68.4	225	7.2	21.4	16			26
80.2	145	11.7	32.7	23			81 3/8
46.4	165	6.1	25.5	17			53
171.1	21	5.1	8.0	25			27 3/4
61.4	50	5.5	17.9	22			75
33.0	159	12.0	69.5	23			28 1/2
197.2	86	19.6	21.7	21			52
47.1	483	8.2	39.2	16			26 1/2
164.3	135	16.4	19.8	26			31 3/8
n.a.	(2)	-	200.0	n.a.			107 1/2
10.0	76	2.9	73.7	18			22 1/8

TABLE E-5

HOLDING AND TRADING OF 19 SELECTED STOCKS BY LARGE CANADIAN MUTUAL FUNDS AND LARGE TRUST COMPANY INVESTMENT FUNDS IN 1966

	1	2	3	4	5	6
Selected Stocks Held and Traded	Number of shares o/s at year-end (000's)	Number of shares held by mut. funds (000's)	Number of shares held by all inst. (000's)	Shares held by mut. funds as % of shares o/s %	Shares held by all inst. as % of shares o/s %	Total shares traded all exchanges (000's)
Alcan Aluminium................	31,137	1,227	3,136	3.9	10.1	4,449
Canadian Breweries............	21,762	120	3,620	0.6	16.6	3,927
Denison Mines..................	4,475	235	501	5.3	11.2	852
Dominion Foundries............	15,397	1,269	4,178	8.3	27.1	800
Dominion Textiles.............	2,596	472	912	18.2	35.1	484
Home Oil "A"..................	2,684	250	n.a.	9.3	n.a.	1,280
Industrial Acceptance.........	5,963	767	1,671	12.9	28.0	614
M. Loeb.......................	2,586	518	733	20.0	28.3	744
MacMillan Bloedel.............	20,856	1,045	2,615	5.0	12.5	1,164
Moore Corporation.............	7,070	523	2,416	7.4	34.2	403
Noranda Mines.................	11,932	550	1,618	4.6	13.6	1,092
Oshawa Wholesale "A"..........	2,295	456	n.a	19.9	n.a	271
Royal Bank of Canada..........	6,652	274	2,218	4.1	33.3	464
Simpsons......................	7,434	310	2,293	4.2	30.8	696
Steinberg's "A" (1).............	3,653	858	n.a	23.5	n.a	324
Stelco........................	24,139	1,261	5,498	5.2	22.8	1,968
Union Gas Company (2)............	14,954	1,943	5,092	13.0	34.1	1,212
Velcro Industries (3)............	3,235	146	n.a.	4.5	n.a.	-
Westcoast Transmission........	6,666	443	683	6.6	10.2	1,380

NOTES:

(1) Split 2 - 1, Jan 27th

(2) Split 3 - 1, June 23rd

(3) Split 10 - 1, Oct. 5th

n.a. = Information was not available

\- = Zero

TABLE E-5 (CONT'D.)
HOLDING AND TRADING OF 19 SELECTED STOCKS BY LARGE CANADIAN MUTUAL FUNDS AND LARGE TRUST COMPANY INVESTMENT FUNDS IN 1966

7	8	9	10	11	12	13	14
Shares held by mut. funds as % of trading %	Trading by mut. funds (gross) (000's)	Trading by mut. funds as % of 2X total trad. %	Trading by mut. funds as % of holding %	Price to earnings ratio	Number of funds holding any shares of company	Number of funds holding more than 5% of m.f. holdings	Year-end price of selected stocks $
27.6	359	4.0	34.2	15			30 1/8
3.0	576	7.3	152.7	18			7 1/4
27.6	91	5.3	47.2	27			56 1/2
158.7	88	5.5	7.2	15			18 1/4
97.5	348	36.0	85.2	11			28 1/2
19.5	156	6.1	75.2	21			23 3/4
124.9	76	6.2	10.3	10			21
69.7	463	31.1	92.3	18			10 1/8
89.8	213	9.2	20.1	13			23 1/4
129.8	53	6.6	10.4	21			86 1/2
50.4	108	4.9	18.4	14			49 1/2
168.1	158	29.2	38.8	21			25
59.2	11	1.2	4.0	18			69
44.6	37	2.7	14.0	23			27 3/4
264.8	106	16.4	16.5	20			18 5/8
64.1	120	3.0	9.1	13			20
160.3	205	8.5	15.6	25			10 1/2
n.a	84	n.a.	114.9	n.a.			35
32.1	338	12.2	117.8	76			25 1/4

TABLE E-6

HOLDING AND TRADING OF 19 SELECTED STOCKS BY LARGE CANADIAN MUTUAL FUNDS AND LARGE TRUST COMPANY INVESTMENT FUNDS IN 1967

	1	2	3	4	5	6
Selected Stocks Held and Traded	Number of shares o/s at year-end (000's)	Number of shares held by mut. funds (000's)	Number of shares held by all inst. (000's)	Shares held by mut. funds as % of shares o/s %	Shares held by all inst. as % of shares o/s %	Total shares traded all exhanges (000's)
Alcan Aluminium...............	32,270	1,241	1,624	3.8	5.0	4,410
Canadian Breweries............	21,762	101	2,573	0.5	11.8	3,234
Denison Mines.................	4,475	159	183	3.6	4.1	972
Dominion Foundries............	15,425	1,320	1,979	8.6	12.8	1,389
Dominion Textiles.............	2,596	538	606	20.7	23.4	693
Home Oil "A"..................	2,687	251	328	9.3	12.2	1,338
Industrial Acceptance.........	5,974	764	959	12.8	16.0	806
M. Loeb.......................	2,613	326	372	12.5	14.2	1,234
MacMillan Bloedel.............	20,856	970	1,358	4.7	6.5	1,484
Moore Corporation (1).............	28,283	1,880	2,670	6.7	9.4	1,899
Noranda Mines.................	11,940	536	686	4.5	5.8	1,288
Oshawa Wholesale "A" (2)	5,113	935	1,036	18.3	20.3	816
Royal Bank of Canada (3)	33,264	1,381	2,256	4.2	6.8	2,539
Simpsons......................	7,459	335	733	4.5	9.8	629
Steinberg's "A"...............	3,696	530	707	14.3	19.1	754
Stelco........................	24,139	1,137	1,658	4.7	6.9	2,459
Union Gas Company.............	14,970	1,456	1,823	9.7	12.2	1,603
Velcro Industries.............	3,273	24	37	.7	1.1	n.a.
Westcoast Transmission........	6,682	406	505	6.1	7.6	908

NOTES:
(1) Split 4 - 1, May 12th
(2) Split 2 - 1, Oct. 11th
(3) Split 5 - 1, June 27th
n.a. = Information was not available
\- = Zero

TABLE E-6 (CONT'D.)

`HOLDING AND TRADING OF 19 SELECTED STOCKS BY LARGE CANADIAN MUTUAL FUNDS AND LARGE TRUST COMPANY INVESTMENT FUNDS IN 1967

7	8	9	10	11	12	13	14
Shares held by mut. funds as % of trading %	Trading by mut. funds (gross) (000's)	Trading by mut. funds as % of 2X total trad. %	Trading by mut. funds as % of holding %	Price to earnings ratio	Number of funds holding any shares of company	Number of funds holding more than 5% of m.f. holdings	Year-end price of selected stocks $
28.1	249	2.8	20.2	16	37	6	28 3/8
3.1	30	0.5	27.3	18	4	3	7 1/2
16.4	137	7.1	69.5	31	14	3	82 1/2
95.0	95	3.4	7.3	15	34	5	19 1/4
77.6	37	2.7	7.3	-	22	6	17 1/2
18.7	121	4.5	48.3	21	11	4	25 1/8
94.7	70	4.3	9.1	10	19	3	20
26.4	317	12.9	75.3	16	13	7	12 3/4
65.4	65	2.2	6.5	16	30	4	23 1/2
99.0	299	7.9	24.9	27	36	5	29 1/4
41.6	206	8.0	37.9	14	35	4	51 3/4
114.6	12	.8	1.7	26	14	3	31
54.4	128	2.5	15.5	17	30	3	15 5/8
53.3	22	1.8	6.9	21	17	4	33 1/2
70.3	286	19.0	41.2	17	9	5	17
46.3	280	5.7	23.3	12	38	4	20 1/4
90.8	589	18.4	34.7	26	23	6	15 3/8
n.a.	233	n.a	274.4	n.a.	9	6	57
44.7	169	9.3	39.8	31	16	4	21 1/2

APPENDIX C

INCOME TAXATION OF CANADIAN MUTUAL FUNDS, THEIR SHAREHOLDERS AND UNITHOLDERS

The purpose of this appendix is to outline the more important income tax implications of Canadian mutual funds organized as trusts or as companies; as noted in paragraph 1.57 other methods of organization are possible but are not currently used for publicly distributed mutual funds. The appendix is not intended as a detailed analysis, but rather to indicate some of the principal matters to be considered by mutual fund organizers and by prospective Canadian investors in mutual funds. No attempt is made to consider the income tax implications for non-residents of Canada who invest in Canadian mutual funds, nor for Canadians who invest in foreign mutual funds. The most important consequence of income tax for mutual funds, the distinction between capital gains and income, is not discussed; it is referred to in Chapters I and III, particularly in paragraphs 1.60 to 1.62 and 3.47. The terms "capital gains" and "income" are used in this appendix in the technical sense of income tax law; the legal position stated is that under the Income Tax Act (Canada). The position in those provinces which impose separate income tax is substantially identical.

The various income tax positions available for incorporated or trusteed mutual funds under Canadian law can best be explained through their division into five classes, as follows:

<u>Distributing trusteed funds</u> -

(a) mutual funds organized as trusts, which either distribute all their income annually to unitholders or could be required by unitholders to do so under the terms of the relevant trust instrument;

Non-distributing trusteed funds -

(b) mutual funds organized as trusts, which do not distribute their income annually and could not be required to do so by unitholders; we are aware of no mutual fund operating in Canada at the time of writing which falls within this class, and for reasons indicated below we doubt that any will be organized while the income tax law remains as at present;

Distributing incorporated funds which do not comply with section 69 -

(c) mutual funds organized as companies which do not comply with the conditions specified in section 69 of the Income Tax Act for recognition as investment companies, and which distribute all or substantially all of their income annually to shareholders;

Non-distributing incorporated funds which do not comply with section 69 -

(d) mutual funds organized as companies which do not comply with the conditions specified in section 69 of the Income Tax Act for recognition as investment companies, and which do not distribute all or substantially all of their income annually to shareholders; and

Incorporated funds which comply with section 69 -

(e) mutual funds organized as companies which comply with the conditions specified in section 69 of the Income Tax Act for recognition as investment companies; such mutual funds must distribute substantially all of their income annually to shareholders.

The treatment under Canadian income tax law of dividends paid by taxable Canadian corporations is of considerable importance in an explanation of the relevance of the five classes of mutual funds. When such a dividend is received by a Canadian taxpayer other than a corporation, it is taxable as income but the recipient is ordinarily entitled to deduct from his income tax otherwise payable, an amount equal to 20% of the dividend. This is referred to as the "20% dividend tax credit". Where a taxable Canadian corporation receives dividends from another taxable Canadian corporation, the dividends are ordinarily free of income tax to the recipient. There are exceptions to each of these rules which are not relevant for present purposes.

Capital gains are received free of income tax by all five classes of mutual funds, as they are by all Canadian taxpayers. In addition, a gain realized by a taxable Canadian shareholder or unitholder on the redemption of shares or units is, with one exception, treated as a capital gain unless it was realized as part of a trading operation; the single exception, relating only to incorporated mutual funds which do not distribute all of their taxable income to their shareholders, is discussed below. When an incorporated mutual fund distributes capital gains in cash to its Canadian shareholders, they receive the dividend as taxable income except in the case of any shareholders which are themselves taxable Canadian corporations. Canadian taxpayers other than corporations are entitled to the 20% dividend tax credit on such dividends, as on all dividends from taxable Canadian corporations. There are other methods for the distribution of capital gains by an incorporated mutual fund to its shareholders but until the mutual fund is wound up there is no effective way to make such distributions completely free of income tax at the level either of the mutual fund or of the shareholder, or at both levels. Capital gains distributed by trusteed mutual funds to their unitholders are received by the unitholders as capital gains.

In the taxation of income, the rules differ among the five classes of mutual fund both in the treatment of income received by the mutual fund and in the treatment of that income when received by the shareholders or unitholders. The general rule applicable to trusteed mutual funds, as to trusts generally under section 63 of the Income Tax Act, is that the trustee is subjected to tax at the steeply graduated individual rates on the income of the trust. He is, however, entitled to deduct in the determination of a year's income, that portion of the income paid or payable to unitholders in the year. An amount is considered payable if actually paid or if the unitholder is entitled to demand payment. These rules account for the distinction between distributing trusteed funds and non-distributing trusteed funds, and for the fact that no mutual funds are organized as non-distributing trusteed funds. The application of tax at the individual rates to the income of a large non-distributing trusteed fund would be prohibitive.

While the distributing trusteed fund provides the advantage of income tax avoidance at the level of the mutual fund, it should be remembered that the income is taxed annually to unitholders. This is true even if they in fact do not receive the income. Even though the right to the 20% dividend tax credit for that portion of the income which is attributable to dividends from taxable Canadian corporations also "flows through" the distributing trusteed fund, such mutual funds are often inappropriate investments for persons who are subject to income tax at high marginal rates. On the other hand, they can be very suitable for persons in lower tax brackets.

Incorporated mutual funds other than those which comply with section 69 are subject to the tax treatment applied to corporations generally. Income is taxed federally (subject to special allowances for provincial credits) at a rate, including the special old age security tax, of 21% on the first $35,000 of annual income and 50% on the annual income in excess of that amount, plus a surtax of 3% on the resultant tax. Dividends paid are treated as income to their recipients, even if derived from capital gains of the company, but those shareholders which are taxable Canadian corporations need pay no tax on the dividends and other taxable Canadian shareholders can take advantage of the 20% dividend tax credit.

In the five classes of mutual funds set out early in this memorandum, we distinguish between incorporated funds not complying with section 69 that do, and those that do not, distribute their income annually. This distinction reflects certain provisions of the Income Tax Act which were designed to prevent the use of share redemptions to avoid the payment of tax on dividends. Section 82 of the Income Tax Act contains a complicated definition of undistributed income on hand; briefly, it is designed to include the income which a company could have, but has not, distributed by way of dividend. By section 81, where a share redemption is paid for by a company which has undistributed income on hand, the redemption price is considered to be wholly or partially derived from such undistributed income and is to that extent treated as a dividend. This rule is applicable to non-distributing incorporated funds. In

theory, the rule could affect an incorporated mutual fund which complies with section 69, although the requirement imposed by that section for regular distribution of substantially all the income of companies which comply with it reduces the potential impact of the rule.

As a practical matter, the rule described in the preceding paragraph has not been a serious problem for mutual funds. The 20% dividend tax credit and the special treatment for taxable Canadian corporations are available. In addition, the relevant definitions operate in such a way that, as the total number of shares which a mutual fund has outstanding increases, the amount of undistributed income on hand allocable to each share decreases. As a result, with a mutual fund that is constantly selling more shares than it is called upon to redeem, the portion of a redeeming shareholder's payment deemed to be derived from undistributed income on hand is ordinarily small. The corollary of this is that if a shareholder redeems immediately after his purchase, a portion of his redemption price may be taxed as a dividend to him although it in fact includes no income element. Serious potential problems could arise from the operation of these provisions, and they merit careful analysis by the responsible authorities.

The income tax treatment of incorporated Canadian mutual funds and their shareholders produces comparatively harsh results in its application to income derived from sources other than dividends paid by taxable Canadian corporations, such as interest income and dividends from foreign corporations. Such income is taxable to the recipient mutual fund, and is taxable again when paid as a dividend to shareholders of the mutual fund, although they receive the benefit of the 20% dividend tax credit. Section 69 of the Income Tax Act was enacted to lessen this burden, although subject to restrictions designed to prevent its improper use. The section applies to closed-end investment companies as well as to mutual funds. Those which elect to comply with the conditions it contains are subject to tax, including old age security tax, at a rate of 21% of their annual income plus a 3% surtax. In order to take advantage of the lower rate of tax, the incorporated mutual fund must comply with a number of conditions. 19 of the 45 incorporated Canadian mutual funds

which advised the Committee of their policy on this point indicated that at December 31, 1967, they complied with section 69. The importance of the relevant conditions is accentuated by the fact that these 19 mutual funds represented, at that date, 67% of the assets of all Canadian mutual funds qualified for sale in Canada. The conditions are set out in a footnote.*

Extensive changes in the rules and requirements described in this appendix may be expected to result from the detailed analysis of the Canadian income tax law which is in progress at the time of writing.

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* To obtain the benefit of the lower rate of tax for a taxation year, section 69 requires that a corporation comply with the following conditions:

(a) at least 80% of its property was, throughout the year, shares, bonds, marketable securities or cash,

(b) not less than 95% of its income for the year was derived from investments mentioned in paragraph (a),

(ba) not less than 85% of its gross revenue for the year was from sources in Canada,

(bb) not more than 25% of its gross revenue for the year was from interest,

(c) at no time in the year did more than 10% of its property consist of shares, bonds or securities of any one corporation or debtor other than Her Majesty in right of Canada or of a province or a Canadian municipality,

(d) at no time in the year was the number of shareholders of the corporation less than 50, none of whom at any time in the year held more than 25% of the shares of the capital stock of the corporation, and

(e) an amount not less than 85% of its taxable income plus exempt income for the year (other than dividends or interest received in the form of shares, bonds or other securities that have not been sold before the end of the taxation year) minus

(i) 21% of its taxable income for the year, and

(ii) taxes paid in the year to other governments,

was distributed to the shareholders before the end of the year.

APPENDIX D

APPLICATIONS FOR DECLARATIONS OF REASONABLENESS OF MANAGEMENT FEES AND SALES CHARGES

In paragraphs 10.73 to 10.92 of the report, proposals are made for controls to be applied to the levels of management fees and sales charges until the development of effective competition at the consumer level. An important part of such proposals is the procedure they contemplate under which a judicial declaration may be obtained that the existing or a proposed level of management fees or sales charges is or would be reasonable. That procedure would be designed to attain two objectives: to provide an effective right of appeal from the decisions of administrators, and to produce a result which would be nationally uniform. The first of these objectives is adequately considered in the text of the report, as are the substantive questions to be considered by the court on the application. We are here concerned only with the necessary procedures to produce a nationally uniform result. We also refer, for the convenience of the interested reader, to precedents for these procedures in other legislation.

Procedures to Produce a Nationally Uniform Result

If the relevant legislation is administered by a national administrative agency, as that term is defined in paragraph 19.03 there will be no difficulty in arriving at a nationally uniform result. The procedures here being considered assume provincial administration, and therefore provincial legislation (although provincial legislation could be effectively administered by a national administrative body). Their effective operation will be dependent upon legislative uniformity. This report is submitted to each provincial government as well as to the federal government, and it is to be hoped that each province will

implement the proposed regulatory scheme on a uniform basis. However, allowance must be made for the possibility that this will not occur. Each province which implements this report should therefore include in the relevant legislation a provision for the promulgation of regulations which would identify the provinces with substantially uniform legislation governing management fees and sales charges. In this appendix, all provinces with such uniform legislation are referred to as "uniform provinces".

It is fundamental to our proposed scheme that the judicial proceedings will be commenced not as an appeal from the decision of the administrator, but by a motion initiated by the management company or distribution company. There are a number of reasons for this:

(a) the decision of the administrator will technically affect only the mutual fund, as a rejection of its prospectus; in addition, it may be based on a variety of grounds apart from the reasonableness of management fees or sales charges; and it may be preferable for the judicial proceedings to be commenced before the administrator has actually rejected a prospectus;

(b) it would be difficult to adapt the judicial proceedings to each of the three categories of circumstances described in paragraph 10.81 if it was necessary for them to take the form of an appeal from the administrator's decision; and

(c) the province in which the judicial proceedings were taken might differ from that where the administrator concerned was located, and it would therefore be inappropriate to designate the proceedings as an appeal.

When it becomes apparent to a management company or a distribution company that agreement will not be reached with one or more administrators concerning the level of management fees or sales charges charged or proposed, it will apply by originating notice of motion for a declaration of reasonableness. The motion will be made before the courts of the province under the laws of which the mutual fund was organized. Special provisions will be desirable to deal with foreign mutual funds, and perhaps also with cases where the prov-

ince of organization of the mutual fund is not a uniform province. We make no specific proposals concerning such cases; the former will be affected by the negotiations proposed in paragraph 16.68 and the latter should be considered in inter-provincial discussions.

Notice of the motion will be given to the administrator in every uniform province where the mutual fund is registered. If those responsible for the motion intend that the mutual fund should register in another uniform province as well, and wish the result to be effective there, notice should also be given to the administrator in that province. Any or all of the administrators given notice would be entitled to be represented on the hearing of the motion and in subsequent proceedings, although it seems more likely that they will co-operate to retain a single counsel to act on behalf of all of them. In addition, while notice to holders of shares or units would not be necessary, any such holders could be represented in the proceedings.

The originating notice of motion will be heard on the basis of affidavit evidence submitted by interested parties. In some cases, the judge who hears it might decide the matter without further proceedings. This will be feasible, for example, if the application is unopposed and the judge concludes that the fees or proposed fees are reasonable. In a case where the application is contested, particularly if the facts are in dispute, the judge will ordinarily make an order to direct the trial of an issue. The order will specify the matter to be resolved, and will determine the parties to the action, upon what basis pleadings should be exchanged and any other necessary matters concerning pre-trial procedure.

The judge at the hearing of the originating notice of motion will also have power to determine who should carry the burden of proof at the trial. If the management fee or sales charge in question is higher than the prevailing levels in the mutual fund industry, he will ordinarily require the applicant to carry that burden; if it is lower, he will ordinarily require any administrator who challenges the application to carry the burden of proof. In many cases the judge will be unable or unwilling to make such an order, in which event the question would be reserved for the judge at trial.

Pre-trial proceedings and the trial itself will be conducted in accordance with the order made on the originating notice of motion. If the application is successful and a declaration of reasonableness is made, the resultant order will (when it becomes binding after the completion of appeals or the expiry of appeal periods) become effective in each uniform province where notice of the originating notice of motion has been served upon the administrator. It will be necessary to establish appropriate procedures whereby the order can be registered with the courts of the provinces concerned; such procedures can readily be modelled on those adopted under other legislation which prescribes that a decision of the courts in one province will be binding in another province. Examples of such legislation are discussed below. In most cases, the arrangements for registration of the decision in other provinces include precautions to ensure that the court which made the order in fact had jurisdiction over those affected by it. That should not be a difficulty in the present case.

In cases where the application is rejected, it will not ordinarily be necessary to issue an order in the various uniform provinces because the decision will have no substantive effect; it will be only a refusal to declare that the fee or charge is reasonable, rather than an affirmative statement that it is unreasonable. The only exception will be cases falling within category (c) of paragraph 10.81 where the court exercises one or both of the powers proposed in paragraph 10.82 by determining what fee or charge would be reasonable or by ordering the management and/or the distribution company to pay money to the mutual fund. If difficulties are encountered in the enforcement of such orders, it should be possible for the administrators or the management or distribution company concerned to register it in their several provinces.

Precedents in Other Legislation

The proposal for recognition of a decision made in one province by the courts of other provinces has a number of precedents. The most important are the Reciprocal Enforcements of Judgments Acts, in effect in the majority of provinces. These statutes permit a judgment made by the courts of a province and requiring the payment of money to be registered as a judgment in the

court of another province with uniform legislation, and to be enforced in the latter province. Provinces with uniform legislation are recognized by regulations passed under the several Acts. Statutes which are very similar in principle are the Reciprocal Enforcement of Maintenance Orders Acts. These, also, relate to the judgments or orders which require the payment of money.

Another legislative precedent is the provisions of Highway Traffic Acts and equivalent statutes which permit the enforcement in one jurisdiction of an order suspending a driver's license made in another jurisdiction. These provisions can have the effect that a particular jurisdiction will enforce against one of its residents a suspension of his driver's license ordered by the courts of another jurisdiction in circumstances in which the enforcing jurisdiction would not have made such an order.

The validity of provincial recognition of judicial decisions in other provinces was upheld in A.-G. Ontario v. Scott [1956] S.C.R. 137.

APPENDIX E

CONTENT OF MUTUAL FUND PROSPECTUSES

At an early stage in our work, we decided against conducting a separate study of the requirements for disclosure in mutual fund prospectuses. Form 12 under The Securities Act, 1966 (Ontario) which governs prospectus disclosure for mutual funds in that province, was adopted after careful study and we concluded that additional experience was needed under it and under the corresponding forms in other provinces with parallel regulations before a complete review of this area is attempted. In spite of that decision, a number of the recommendations made as a result of studies of various other aspects of mutual fund operations will have a direct effect on the requirements for prospectus disclosure. The purpose of this appendix is to summarize such recommendations. The appendix does not include references to recommendations which will alter the actual contents of the prospectus, as distinguished from the requirements for prospectus content. For example, the conclusions concerning forward pricing in paragraphs 13.59 to 13.70 will necessitate adjustments in the prospectus description of the price of shares or units, but will not necessitate a change in the provisions of Form 12 which require disclosure of price information.

In paragraphs 14.58 to 14.60 we propose the adoption of requirements for summary prospectuses, and provide an example in paragraph 14.59 of the form we think appropriate. No attempt is made in this appendix to state the contents of the summary prospectus; they are adequately indicated by paragraph 14.59. Nor is any attempt made to set out the changes in Form 12 which will be made necessary by the proposals concerning financial disclosure in Chapter XV; this

appendix relates only to non-financial matters.

Copies of the Securities Act (Ontario) and the regulations thereunder, or of the equivalent legislation and regulations in other provinces which have adopted parallel statutes will be readily available to the interested reader. We therefore do not set out the provisions of that Form, but provide a sufficient indication of their contents, where relevant, so that the following discussion will be comprehensible even to the reader without a copy of Form 12. References throughout to "items" are to the provisions of Form 12.

Item 1 - Price of Securities on Sale or Redemption

a) As stated in paragraph 10.42, the prospectus should describe sales charges computed as a percentage of the amount paid and as a percentage of the amount actually invested.

b) The proposals in paragraphs 13.89 to 13.100 concerning the circumstances in which mutual funds should be permitted to issue shares or units for a consideration other than cash, or to redeem them by delivery of securities, should be reflected by a specific requirement for the policy of the mutual fund on these points to be set out in the prospectus.

c) In any case where the sale is at a price in excess of net asset value and a commission is paid to the sales outlet, unless sales are made exclusively through employees of the distribution company, a specific statement should be required that the sales outlet is not prohibited from reducing the purchase price by waiving a portion or all of its commission. This will reflect the prohibition of retail price maintenance proposed in paragraphs 10.49 to 10.71.

Item 2 - Method of Distribution

The definition of "distribution contract" in paragraph 11.10 is inconsistent with the definition of "principal distributor" in this item. The latter should be adjusted, or omitted in favour of the former.

Item 3 - Name and Incorporation of Issuer

No recommendation in the report would affect this item.

Item 4 - Share and Loan Capital Structure

Extensive adjustments in this item will be required as a result of the proposals in Chapter V concerning equity structure; in Chapters V and XII concerning the extent and nature of the mutual fund's power to borrow money; and in paragraph 12.73 concerning the acquisition by mutual funds of subsidiary companies.

Item 5 - Description of Business

a) It is unlikely that any organization able to qualify as a mutual fund under the recommendations made in this report will have any additional business activity to disclose.

b) In paragraphs 9.42 to 9.46 we propose a scheme for the disclosure of potentially abusive transactions. While that scheme does not contemplate prospectus disclosure its implementation would make unnecessary the requirement presently included in item 5 for disclosure of transactions with affiliates. Any such transaction which might have a material effect on the mutual fund would be caught by the general requirement for disclosure of other material information.

Item 6 - Fundamental Policies of the Issuer, and
Item 7 - Policies With Respect to Security Investments

a) These two items will be extensively affected by the proposals made in this report. Some of the activities enumerated in item 6 would be prohibited for mutual funds by our proposals in Chapters V, XII, and elsewhere. In addition, in paragraphs 12.95 to 12.99 we propose that more attention should be given to the precision of the statements of investment policies and of investment practices, and this proposal should also be reflected in adjustments to these items. The disclosure of conventional or non-conventional categorization could conveniently be included under this item.

b) The requirement in item 6 that disclosure must be on a five-year historical basis is inconsistent with the approach to comparative information proposed in paragraphs 15.14 to 15.20.

Item 8 - Diversification of Assets

This item should be adjusted to coincide with the approach to restrictions on investments in any single issuer which is proposed in paragraphs 12.61 to 12.73. In particular the concept of related mutual funds should be introduced through a requirement for disclosure of the combined holdings of mutual funds under common management.

Item 9 - Tax Status of Issuer, and
Item 10 - Tax Status of Security Holder

Reference should be made to Exhibit 15-A and to the comments in paragraph 15.27.

Item 11 - Promoters

This item, as worded, refers to certain transactions which would be inconsistent with some of the proposals in this report, and should be modified accordingly. Disclosure should be required of any escrow arrangement established pursuant to paragraph 7.25, and of any written undertaking for the non-disposal of shares or units in addition to the escrowed shares or units in effect pursuant to that paragraph.

Item 12 - Pending Legal Proceedings

The item should make specific reference to any proceedings in progress or resolved within the previous year concerning the reasonableness of management fees and sales charges, as contemplated by paragraphs 10.73 to 10.92 (particularly paragraph 10.81) and Appendix "D".

Item 13 - Description of Shares Offered

a) A number of the characteristics referred to are inconsistent with the proposals for equity structure made in Chapter V, and the item should be modified accordingly.

b) The item should require a detailed statement of voting rights, which would include a reference to the matters upon which voting rights are required as stated in paragraph 6.55, and to any other matters upon which shareholders or unitholders have the right to vote.

c) The penalty for short-term redemptions proposed in paragraph 13.84, and any other redemption charges which may be applicable, should be disclosed in answer to this item.

Item 14 - Issuance of Other Securities

It is unlikely that this item will ever be relevant under the regulatory scheme proposed in this report. Issuance of debt instruments to the public would be prohibited under the proposal in paragraph 5.74. Two classes of equity securities could be distributed to the public, but there would be little advantage in this since the two classes would be required to have equal financial rights under the proposal in paragraph 5.58.

Item 15 - Dividend Record

Exhibit 15-D and the textual discussion of that exhibit deal with the information required under this item.

Item 16 - Directors and Officers, and
Item 17 - Remuneration of Directors and Senior Officers

a) For reasons indicated in Chapter III, particularly paragraph 3.14, these items should be extended to require information concerning the backgrounds of the individuals responsible for the investment management of the mutual fund.

b) The requirement in item 17 for disclosure of salaries should be modified in accordance with the comments made in paragraph 15.28.

Item 18 - Custodian of Portfolio Securities

a) The statement that the name of the custodian may be omitted if it is a bank to which the Bank Act (Canada) applies should be deleted. The discussion in paragraph 16.28 is relevant here.

b) The information disclosed concerning the custodian should be sufficient to establish compliance with paragraphs 8.05 to 8.23.

c) As proposed in paragraph 8.12, information concerning any connection between the custodian and the mutual fund, management company or distribution company should be included.

d) If an exemptive order is granted as contemplated by paragraph 8.09 to permit assets to be kept in custody outside Canada, the order and the procedures actually followed should be disclosed.

e) In accordance with paragraph 8.18, a statement of the maximum amount to be deposited in a bank account or bank accounts should be included.

Item 19 - Statement of Functions of Issuer and Distributor of Securities

The requirements concerning disclosure of brokerage should be modified in accordance with paragraphs 15.44 to 15.46.

Item 20 - Relationship to Issuer

a) In paragraph 9.26 we propose a definition of "associates" to be used for purposes of the requirements imposed under Chapter IX. This item should be amended to make use of that definition.

b) Disclosure of the management expense ratio described in paragraph 10.46 should be required.

Item 21 - Options to Purchase Securities

Under the proposal in paragraph 5.60, mutual funds would be prohibited from the issuance of options. However, that proposal would not affect mutual funds with options already outstanding. Detailed information, at least as extensive as that contemplated by this item, should be required in any such case.

Item 22 - Principal Holders of Securities

This item should be modified to the extent necessary to carry out the proposals in paragraphs 9.52 and 9.56.

Item 23 - Interest of Management and Others in Material Transactions

Comment b) made above in the comments on item 5 is relevant here.

Item 24 - Auditors, Transfer Agents and Registrars

The information concerning the auditor should be extended to show compliance with paragraphs 6.69 to 6.87. In cases of the type described in paragraph 6.78, the prospectus as well as reports to shareholders or unitholders should include information concerning the nature of the relationship between the auditor, or an associate of the auditor, and the mutual fund.

Item 25 - Material Contracts, and
Item 26 - Other Material Facts

No recommendation in the report would affect these items.

Other Matters

a) An item should be added to deal with arrangements for the custody of shares or units of the mutual fund, in any case where certificates representing such shares or units are not delivered as a matter of routine to the purchaser. The item should require information sufficient to establish compliance with paragraphs 8.41 to 8.50.

b) Where contractual plans are sold, an item should require disclosure of information concerning the custodial arrangements proposed in paragraphs 8.52 to 8.63.

c) The prospectus should contain a detailed statement of all available rescission rights. Sections 63 and 64 of The Securities Act (Ontario) require disclosure of these rights, but a general requirement to this effect should also be included in Form 12 or its equivalent.

d) In cases where the mutual fund is associated with a bank in the manner contemplated by paragraph 16.25, the prospectus should include information to that effect, as proposed in paragraph 16.28.

e) A general provision should be added to permit the inclusion in the prospectus of additional material to the extent contemplated by paragraph 14.65.

APPENDIX F

PARTIAL LIST OF PERSONS AND ORGANIZATIONS WHO SUBMITTED WRITTEN BRIEFS

The Canadian Institute of Chartered Accountants: Toronto

The Canadian Life Insurance Association: Toronto

The Canadian Mutual Funds Association: Toronto

Corporate Investors Limited: Toronto

DesBrisay, Ian G., Great Pacific Management Co. Ltd.: Victoria

The Investors Group: Winnipeg

Isaac, Russell, Great Pacific Management Co. Ltd.: Victoria

The Life Underwriters Association of Canada: Don Mills

Phillips, Hager & North Ltd.: Vancouver

The Trust Companies Association of Canada: Toronto

United Bond & Share Limited, RoyFund Distributors Ltd. and RoyFund Ltd.: Montreal

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